

2002

Employee benefit plans industry developments - 2002; Audit risk alerts

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Employee Benefit Plans Industry Developments— 2002

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

Notice to Readers

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

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. 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.

The AICPA staff wishes to thank the members of the Employee Benefit Plans Expert Panel; the 2002 Employee Benefit Plans Audit Guide Revision Task Force; Wendalyn Frederick, technical manager, AICPA Professional Standards and Services; and the Office of Chief Accountant, Pension and Welfare Benefits Administration of the U.S. Department of Labor for their contributions to this Audit Risk Alert.

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Employee Benefit Plans Industry Developments—2002

How This Alert Helps You

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

Industry and Economic Developments

The 21st century workforce is more mobile than ever before. One of the most important challenges facing America's 21st century workforce is understanding the need to prepare for a secure financial future.

—*Secretary of Labor, Elaine Chao*

The need for individuals to provide for their own retirement continues to grow in importance. One of the goals of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), signed into law by President Bush in 2001, is to give employees more opportunities to save for their own retirement. Appendix C of this Alert summarizes the major retirement plan law changes resulting from EGTRRA. Also, because of recent events, there has been more attention paid to retirement plans and President Bush, in his State of the Union address, called on Congress to enact new safeguards to protect the pensions of Americans. Be alert to new legislation that will affect benefit plans. (See the "Legislative Developments" section of this Alert.)

Economic Environment

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

While the fourth quarter of 2001 saw a weak U.S. economy with an uncertain outlook, the financial underpinnings of the U.S. economy remained strong. Inflation has been contained, interest rates have been cut, and taxes have been lowered. Similar to 2001, 2002 continues to see volatility in the stock market. Although the economy is believed to be on the brink of recovery, uncertainty continues to spur the volatility as the financial markets react to events in the Middle East, the Enron collapse, financial statement restatements by several large corporations, and other companies' earnings news. As a result, many defined benefit pension plans have experienced market value declines to the extent that plan sponsors must now make contributions. In addition, sponsors of defined contribution pension plans are rethinking company stock versus cash matching contributions and other plan design features.

Recent events also have spurred unprecedented congressional attention to benefit plans especially those that allow company stock as an investment. See the AICPA's Web site at www.aicpa.org for a listing of Enron-related legislation (see the sections of the site called "Enron Crisis" and "Legislative Tracking").

Impact of September 11

When terrorists attacked the World Trade Center, they did much more than kill innocent people and destroy buildings. Since a number of investment banks and brokerage houses and other third-party service providers were located in the World Trade

Center or very close to it, the securities industry was hit hard by the attack. The industry that relies heavily on personal relationships lost a number of professionals who will be hard to replace. Many of these firms needed to relocate from their damaged or destroyed offices and rebuild computer systems. In addition, the four-day halt in securities trading due to the attacks resulted in many service providers being unable to obtain daily prices. Certain third-party service providers may have experienced errors or delays in processing transactions as a result of the problems associated with September 11 events. In addition to pricing delays, some of the problems included trade fails as a result of missing payments from third-party banks, connectivity issues with external service providers (for example, banks or pricing vendors), and manual processing of transactions as a result of system feeds (for example, bank or payroll) not always being available.

As you prepare to conduct audits of plans that may use outside service providers affected by the events centered on the terrorist attacks, you need to realize that these outside service providers may be working in a new business environment. You should gain an understanding of this new environment to adequately plan and perform the audit. Although in certain instances the implications for the service provider's business environment may be temporary, auditors also need to consider the potential for any ongoing, longer-lasting implications. The auditor should ask the plan sponsor or third-party service provider questions regarding errors or issues relating to processing transactions. If available, a report prepared in accordance with SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, may be helpful in obtaining this understanding. See paragraphs 6.07 through 6.17 of the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, with conforming changes as of May 1, 2002 (the Guide), and the new AICPA Audit Guide, *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772), for guidance on the use of SAS No. 70 reports.

Help Desk—A thorough discussion of the ability of auditors to assist their clients in recovering accounting records, obtaining audit evidence, considering the risk of fraud, and other audit-re-

lated matters is offered at www.cpa2biz.com (see the sections of the site called “Resource Centers,” “Disaster Recovery,” and “Guidance for Auditors”). In addition, www.cpa2biz.com offers extensive guidance on accounting, independence, tax, technology, and regulatory considerations. See the AICPA general *Audit Risk Alert—2001/02* (product no. 022280) for a detailed discussion of how the September 11 attacks may affect the business environment, your clients, and the planning of your audits. The general Alert also discusses specific accounting matters related to the September 11 attacks.

Effect of Layoffs and Cost Reductions

Many industries had to deal this year with both the economic decline and the impact of September 11. Hit especially hard were the tourism, hotel, airline, insurance, high-tech, and restaurant industries. As a result, many firms had to start cutting their costs to improve their profitability, resulting in significant layoffs.

The benefit plan administration area at a company can be especially volatile when it comes to layoffs. Significant layoffs can have a serious effect on an entity’s internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, may feel pressured to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and their effect on internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated).

SAS No. 82,¹ *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), 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 caused by fraud.

You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may represent reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

In addition, significant layoffs could result in a change in benefit plan activity (for example, decreased contributions or increased distributions) that should be considered in planning and performing the plan audit.

Some companies have chosen to reduce operating costs by amending employee benefit plans to allow for payment of expenses from the plan instead of from the plan sponsor. There has been a trend toward defined contribution plans charging participants for expenses or paying expenses out of plan forfeitures. In addition, to reduce costs, health and welfare plans are increasing premium copayments or health insurance deductibles or lowering health coverage limits. Such changes in the administration of the plan should be reviewed to determine whether they are in accordance with the plan document and should be considered in planning and performing the audit.

The Department of Labor (DOL) has issued Advisory Opinion 2001-01A and “Guidance on Settlor v. Plan Expenses,” providing guidance on the question of the types of expenses that may be paid from plan assets. Advisory Opinion 2001-01A restates the DOL’s

1. In February 2002, the AICPA Auditing Standards Board (ASB) issued an exposure draft that would supersede Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). See the section “On the Horizon” in this Alert for further information.

position that a determination about whether to pay a particular expense out of plan assets is a fiduciary act governed by the fiduciary responsibility provisions under the Employee Retirement Income Security Act of 1974 (ERISA). The Opinion clarifies the DOL's long-held view that "settlor" expenses, such as those relating to the establishment, design, and termination of plans, are not payable from plan assets. However, it provides that expenses incurred in connection with the implementation of a settlor decision will generally be considered to be appropriate plan expenses. In connection with the issuance of the Advisory Opinion, the DOL has published "Guidance on Settlor v. Plan Expenses," which provides a number of hypothetical examples in which various plan expense issues are both presented and addressed. These two documents may be found on the DOL's Web site at www.dol.gov.

DOL Relief Following September 11, 2001, Terrorist Attacks— Form 5500 and Form 5500-EZ Filing Extensions

In a press release dated September 14, 2001, the DOL's Pension and Welfare Benefits Administration (PWBA), the IRS, and the Pension Benefit Guaranty Corporation (PBGC) announced an extension for filing Form 5500s and Form 5500-EZs. The extension applies to plan administrators, employers, and other entities who file the Form 5500 and Form 5500-EZ that are located in the areas designated as federal disaster areas because of the September 11, 2001, terrorist attacks. The extension also applies to filers located outside the designated disaster areas who are unable to obtain the information necessary for filing from service providers, banks, or insurance companies whose operations are directly affected by the disasters.

Under the extension, those with filings originally due between September 11, 2001, and November 30, 2001, are allowed an additional six months plus 120 days to file. Filers on an extension that expired between September 11, 2001, and November 30, 2001, were allowed an additional 120 days to file. Filers who have difficulty in meeting filing deadlines because of disruption of transportation and delivery of documents by mail or private delivery service resulting from the disasters, and who did not other-

wise qualify for the extensions described above, had until November 15, 2001, to make their Form 5500 and 5500-EZ filings. Please note that these extensions cannot be extended further by filing a Form 5558.

Filers entitled to the extension relief described here should check Part 1, Box D, on the Form 5500, or Part 1, Box B, on the Form 5500-EZ, and attach a statement labeled “September 11, 2001 Terrorist Attack” that explains the basis for the extension being claimed under this release.

Help Desk— Filers who have additional questions may contact the PWBA help desk at (866) 463-3278 or at its Web site at www.dol.gov/dol/pwba.

Extension Permits Temporary Plan Loans and Extensions of Credit After Terrorist Attacks

On September 28, 2001, the DOL published a proposed amendment to an existing class exemption that would allow plans to receive interest-free loans and extensions of credit from related parties. The proposal was designed to address problems faced by plans as a result of the terrorist attacks that occurred September 11, 2001.

The September 11, 2001, incidents may have caused temporary cash flow problems that affect essential plan operations. Interest-free loans or extensions of credit could be used to facilitate transfers of all or part of participants’ accounts from one investment option to another, participant loans, temporary overdraft protection, or participant withdrawal requests.

The proposed exemption allowed plans to receive temporary loans and extensions of credit from related parties, like employers, if certain conditions were met. The action amended an existing exemption—Prohibited Transaction Exemption (PTE) 80-26—and is similar to an amendment granted in 2000 in anticipation of Y2K problems. The DOL has authority to provide administrative exemptions for transactions that otherwise would be forbidden under ERISA.

The conditions of the exemption, which are identical to PTE 80-26, allowed loans and extensions of credit for no more than 120 days,

beginning September 11, 2001. All loans were required to be repaid by January 9, 2002. Among the conditions of the temporary exemption were requirements that:

- No interest or other fee is charged to the plan and no discount for payment in cash is relinquished by the plan.
- The loans and extensions of credit are unsecured.
- Proceeds of the loans and extensions of credit are used only for purposes incidental to ordinary plan operations that are affected by the September 11 terrorist attacks.
- The loans or extensions of credit are not directly or indirectly made by a plan.

Investments in Limited Partnerships and Reporting Such Investments on Form 5500

Pension funds, especially those with large investment portfolios, are more frequently investing in limited partnership private equity funds, which may include hedge funds. These pooled investment funds are lightly regulated and not readily marketable, unlike registered investment funds, commonly known as mutual funds.

This trend of investing in limited partnerships and the recent scrutiny of accounting and disclosure of limited partnership investments in corporate financial statements have precipitated an issue about what employee benefit plan financial statements should disclose about a plan's investments in limited partnerships.

The Guide does not specifically address financial statement or Form 5500 reporting requirements for limited partnerships. Employee benefit plan financial statements report investments at fair value, which would include investments in limited partnerships. Such investments are not consolidated or accounted for on the equity method, as they might be in the plan sponsor's financial statements.

Other required disclosures for limited partnership investments are those applicable under AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. SOP 94-6

requires disclosures about certain significant estimates and current vulnerability due to certain concentrations.

Though not required, additional disclosure is permitted. Consideration should be given to including the following disclosures:

- Description of the plan's ownership interests in the limited partnerships and a summary of investments owned by the partnership investments and the corresponding risk. A riskier, more aggressive investment would warrant consideration of additional disclosure.
- Names of the other partners in the plan's partnership investments and their relationship to the plan (if related parties).
- Methodology in which the partnerships allocate gains, losses, and expenses between the plan and the other partners.
- Related-party transactions with parties in interest related to the limited partnerships (including investment management fees paid).

Paragraph 7.57 of the Guide addresses auditing procedures for limited partnerships.

How a plan reports an investment in a limited partnership on Schedule H to the Form 5500 depends on the nature of the underlying assets of the partnership and whether the partnership elects to file directly with the DOL.

DOL regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity, other than a master trust investment account (MTIA), common/collective trust (CCT), or pooled separate account (PSA), whose underlying assets include "plan assets" (within the meaning of DOL regulation 29 CFR 2510.2-101) of two or more plans that are not members of a related group of employee benefit plans. Making this determination can be complicated and may necessitate legal consultation.

While not required, a Form 5500 filing may be submitted for the 103-12 investment entity (103-12 IE) and, if properly submitted, plans that invest in the entity may report their investment in the

103-12 entity on the Schedule H, item 1c(12), as a single value at the end of the plan year.

In the event that the 103-12 IE does not file directly with the DOL, each participating plan would be required to break out its investment in the entity among the various asset categories on line c of the Schedule H.

Additionally, if a plan invests in a limited partnership, the underlying assets of which do not constitute plan assets, the investment is reported as a single item on Schedule H, item 1c(5).

Outsourcing of Certain Administrative Functions

Employee benefit plan sponsors have typically used third-party service providers in some capacity to assist in administering their plans. With the trend toward company downsizing and increased reliance on technology, many plan sponsors are increasingly turning to outsourcing as a way to reduce costs and increase efficiencies of administering employee benefit plans. Examples include recordkeeping and/or benefit payments or claims processed by outside service organizations, such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators.

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

SAS No. 70, *Service Organizations*, as amended by SAS No. 78 and SAS No. 88 (and conforming changes made due to the issuance of SAS No. 94), provides, among other things, guidance on the factors an independent auditor should consider when auditing the financial statements of a plan that uses a service organization to process certain transactions. Often, the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option; these amounts can be changed by tele-

phone or over the Internet without any record. In these situations, the auditor may not be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70, if available. If a SAS No. 70 report is not available, see paragraph 6.14 of the Guide for guidance.

The auditor should read the entire SAS No. 70 document to determine what was reviewed and tested and over what period and whether there are any instances of noncompliance with the service organization's controls identified in either (1) the service auditor's report or (2) the body of the document (where the results of testing are described). If the service organization's SAS No. 70 report identifies instances of noncompliance with the service organization's controls, the plan auditor should consider the effect of the findings on the assessed level of control risk for the audit of the plan's financial statements and, as a result, the plan auditor may decide to perform additional tests at the service organization or, if possible, perform additional audit procedures at the plan. In certain situations, the SAS No. 70 report may identify instances of noncompliance with the service organization's controls but the plan auditor concludes that no additional tests or audit procedures are required because the noncompliance does not affect the assessment of control risk for the plan.

The plan auditor should also read the description of controls to determine whether complementary user organizations controls are required (for example, at the plan sponsor level) and whether they are relevant to the service provided to the plan. If they are relevant to the plan, the plan auditor should consider such information in planning the audit. The plan auditor should consider the need to document and test such user organization controls. While the plan sponsor may have outsourced administrative functions to a third party, the plan sponsor still has a fiduciary duty to monitor the activities of the third party. Examples of such monitoring

controls, which should be considered in planning and performing the audit, may include:

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

What If the Service Organization Uses Another Service Organization to Perform Certain Functions?

A service organization may use another service organization to perform functions or processing that is part of the plan’s information system as it relates to an audit of the financial statements. The subservice organization may be a separate entity from the service organization or may be related to the service organization. To plan the audit and assess control risk, the plan auditor may need to consider controls at the service organization and also may need to consider controls at the subservice organization, depending on the functions each performs. For further guidance on subservice organizations, see paragraph 6.17 of the Guide and Chapter 5 in the new AICPA Audit Guide, *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772).

Going-Concern Issues for Plans

SAS No. 59, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended, provides guidance to auditors with respect to evaluating whether there is substantial doubt about the plan’s ability to continue as a going concern. For financial reporting

purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to:

- The plan's ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of business.
- Externally forced revision of its operations, or similar actions.

During the course of the audit, the auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminent, potential impact on the plan and should consider the sponsor's plans for dealing with its conditions.

SAS No. 59, as amended, states that the auditor has a responsibility to evaluate whether there is substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor considers the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit to identify conditions and events that, when considered in the aggregate, create substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time. As noted earlier, such conditions may include the need for an extraordinary contribution from the plan sponsor and/or the need to dispose of substantial assets outside the ordinary course of business. Other such conditions and events may include:

- The plan's inability to make benefit payments when they are due
- Plan merger or consolidation
- Debt restructuring

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- Loan defaults
 - The plan's inability to meet minimum funding requirements
 - Bankruptcy of the plan sponsor (or participating employers in multiemployer plans)
 - A nontemporary decline in the market value of investments held by the plan
 - A significant increase in the cost of benefits without the ability to significantly raise contributions
 - Events that endanger the plan's ability to operate, such as if the plan no longer qualifies as a qualified plan

If the auditor determines that substantial doubt about the plan's ability to continue as a going concern does exist, an explanatory paragraph in the auditor's report is required regardless of the auditor's assessment of asset recoverability and amount and classification of liabilities. For example, if the sponsoring employer intends to terminate the plan within 12 months of the date of the financial statements, the auditor should include an explanatory paragraph in his or her report that discloses that fact. SAS No. 59 is amended to preclude the use of conditional language in expressing a conclusion concerning the existence of substantial doubt about the plan's ability to continue as a going concern in a going-concern explanatory paragraph.

The Health Insurance Portability and Accountability Act

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protection for those who move from one job to another, who are self-employed, or who have preexisting medical conditions, and places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations.

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

- Limit the nonconsensual use and release of private health information.
- Give patients new access to their records and let them know who else has accessed them.
- Restrict most disclosure of information to the minimum needed for the stated purpose.
- Establish criminal and civil sanctions.
- Establish requirements for access by researchers and others.

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

The regulations became effective April 14, 2001; however, health care providers will not be forced to fully comply with the changes until April 14, 2003.

In response to this regulation, many claim processors have updated and instituted a variety of confidentiality or indemnification agreements to protect their organizations when third parties request claim information. (See the discussion of confidentiality agreements in the section “Health and Welfare Benefit Plan Issues—Electronic Processing of Benefit Claims and Indemnification Agreements” of this Alert.)

Regulatory Developments

Audits and Regulatory Compliance

Plan sponsors sometimes believe that the annual audit of their employee benefit plans ensures compliance with all the complex rules and regulations set forth by ERISA and the IRS. Consistent with ERISA, audits are conducted in accordance with GAAS and are not designed to verify compliance with the various regulatory provisions. Although the illustrative engagement letter (Exhibit 5-4 of the Guide) contains language to this effect, an expectation gap may still exist. It is important that plan sponsors understand this difference and that the proper design and operations of the benefit plans are the responsibility of the plan administrator and the plan's fiduciaries. Plan sponsors may consider a couple of steps to ensure compliance with the complex rules and regulations set forth by ERISA and the IRS, such as conducting an inventory of all the company's benefit plans. Some plans do not require an audit but do require an annual filing of the Form 5500 with the DOL (for example, unfunded welfare benefit plans). These plans are often overlooked.

Form 5500 Series—What's New for Plan Year 2001?

The Form 5500 and Form 5500-EZ for plan year 2001 remain essentially unchanged from 2000, except for certain changes made to reflect changes in the law, improve forms processing, and clarify the instructions. These include, among other things:

- Expansion of Box D of the Form 5500 to identify filings that are filed pursuant to the Delinquent Filer Voluntary Compliance (DFVC) program or under a special extension pursuant to a federally declared disaster or combat zone. Filers are required to attach the following when Box D is checked:
 - Extension—Form 5558, 7004, or a copy of any other extension request as specified in the instructions.
 - DFVC program—A statement that says the report is filed under the DFVC program. “DFVC Program” and a

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- form line reference must be prominently displayed at the top of the statement.
- Special Extension—A statement citing the authority for the extension. “Disaster Relief Extension” or “Combat Zone Extension” and a form line reference must be prominently displayed at the top of the statement.
 - Modification of the penalty of perjury language above the signature line to address filings submitted electronically.
 - Restructuring of the order of the name and address elements in items 2a and 5 of the Form 5500, to follow a more logical order.
 - Addition of new business activity codes to be used in item 2d for labor unions (813930) and government instrumentalities, and agencies (921000).
 - Addition of new pension plan feature codes for item 8a of the Form 5500: 2Q for an S corporation employer who maintains an ESOP, and 2R for a defined contribution plan that offers participant-directed brokerage accounts as an investment option.
 - Rewording of the instructions for item 9b of the Form 5500 to clarify that all plans have a benefit arrangement regardless of whether they actually paid out benefits during the plan year.
 - Clarification of the instructions for those using amending filings via paper. Only the Form 5500 and accompanying changed schedules or attachments are to be completed. Accordingly, if an attachment to a schedule is being modified or added, but the schedule itself is not being changed, the filer will need to complete only the 5500 and attach the attachment, not the schedule. Additionally, no schedules are to be identified in item 10 of Form 5500.
 - A general schedule instructional change. Where schedules begin with plan and plan sponsor identification items A, B, C, and D, the instructions have been expanded to allow

filers to abbreviate the name of the plan where necessary. Originally, filers were instructed to be certain that the information entered into these elements matched the corresponding information on the Form 5500. In many cases, there was not enough room on the schedules for this.

Certain instructional changes have also been made to the schedules to the Form 5500, as follows:

- Schedule A—The details of the fees and commissions paid to brokers and other persons (item 2) have to be listed in descending order by amount.
- Schedule B—The transition percentage lines, 12m and 13l, have been eliminated to conform to the current version of the law.
- Schedule E—A new item, item 15, has been added asking whether the employer made payments in redemption of stock to terminating ESOP participants. As a result of this new question, item 15 from the 2000 Schedule E becomes item 16.
- Schedule F—The IRS has eliminated this schedule. “Fringe-only plans” are no longer required to file a Form 5500, even for past years in which a Form 5500 filing was required. In the future, the IRS may request information about fringe benefit plans in a different manner. Health and welfare plans that have fringe benefit features should no longer check items 8c and 10c on the Form 5500 filed for the health and welfare plan.
- Schedule H—Defined contribution plans generally may report investments in participant-directed brokerage accounts in a single line on line 1c(15) and the corresponding income (before expenses charged to participant accounts) in line 2c. However, the following investments held in participant-directed brokerage accounts must still be reported in the appropriate asset category in Part I, and the corresponding investment income must likewise be appropriately classified in Part II:

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- Partnerships or joint venture interests
 - Tangible personal property
 - Real property
 - Employer securities
 - Loans
 - Investments that could result in losses that exceed the participant's account balance

Participant-directed brokerage account assets reported in the aggregate on line 1c(15) should be treated as one asset held for investment for purposes of the line 4i schedules, except that investments in tangible personal property must continue to be reported as separate assets on the line 4i schedules.

Note: For a further discussion on such investments, see the section “Self-Directed Investments—The DOL’s Alternative Method of Reporting Participant-Directed Brokerage Window Investments” in this Alert. Be alert that this alternative method of reporting participant-directed brokerage window investments creates an issue with investment reporting in plan financial statements because of generally accepted accounting principles (GAAP) requirements.

- Schedule H—The instructions to line 3b(2) have been clarified to require filers who are electing to defer the attachment of an audit for a short plan year to attach a statement explaining the reason a plan has a short year, and that an audit report will be attached to the subsequent year’s filing covering both years’ financial statements and schedules.
- Schedule H—The instructions to line 3c describing the limited-scope audit have been clarified to specifically exclude securities brokerage firms from the definition of “similar institution” as used in the DOL’s regulations.
- Schedule H—The instructions to lines 4a through 4k have been clarified to emphasize that filers must complete all items and check either “yes” or “no.” The instructions also clarify which filers must attach which items.

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- Schedule I—Item 4k has been added; it asks whether filers of small pension plans are claiming the waiver of the requirement to attach an audit report pursuant to DOL regulation 29 CFR 2520.104-46.
 - Schedule SSA—Page 2, element c: the row of boxes has been divided to direct filers where to enter first and last names and middle initials.
 - Schedule T—Item 4e: a new column of boxes has been added to each of the rows that allows filers to specifically identify the exemption applicable to each identified disaggregated testing group.

The DOL's ERISA Filing Acceptance System (EFAST) continues to process the Form 5500 in two computer scannable formats: *machine print* and *hand print* (the questions are the same, only the appearance is different). Except for those filing electronically, use of computer scannable forms continues to be mandatory for 2001 plan year reports. Filers can choose a machine print format that uses computer software to complete the Form 5500. The machine print forms can be filed electronically, or they may be printed out on computer printers and mailed to the DOL's processing center in Lawrence, Kansas. The printed form will include a computer scannable two-dimensional bar code on the bottom of each page for expedited processing. Plans interested in using the machine print version of the Form 5500 will need to use EFAST-approved software. The list of approved software vendors on the EFAST Web site is updated as software is approved for plan year 2001 filings. For assistance, filers should consult the "How to File" section of the Form 5500 instructions, or they may contact the PWBA's help desk toll-free at (866) 463-3278.

Filers may also choose a hand print format to complete their Form 5500 by hand or typewriter. The hand print format can be filed only by mail (including certain private delivery services) to the DOL's processing center in Lawrence, Kansas. The 2001 hand print version of the Form 5500 is printed in "gray ink" and may be completed using EFAST-approved software.

Information copies of the forms, schedules, and instructions are available on the PWBA's Web site at www.efast.dol.gov. Filers may also order forms and IRS publications 24 hours a day, seven days a week, by calling (800) TAX-FORM ((800) 829-3676).

Small Pension Plan Security Regulation

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

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

Under the new regulation, the administrator of an employee pension benefit plan that is required to complete Schedule I of the Form 5500 is not required to engage an independent auditor, provided certain required disclosures are made in the plan's summary annual report (SAR) and:

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

According to the PWBA, the vast majority of the assets of small plans are "qualifying plan assets." The PWBA believes that the

plans that do not meet the 95 percent threshold will opt for the less expensive bonding alternative to avoid an independent audit of the plan's financial statements.

Definition of Qualifying Plan Assets

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

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

Disclosure Requirements

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

- Except for qualifying plan assets, as previously described, the name of each regulated financial institution holding (or issuing) qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year.
- The name of the surety company issuing the bond, if the plan has more than 5 percent of its assets in nonqualifying plan assets.
- A notice indicating that participants and beneficiaries may, upon request and without charge, examine, or receive copies of, evidence of the required bond and statements received from the regulated financial institutions describing the qualifying plan assets.
- A notice stating that participants and beneficiaries should contact the PWBA regional office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond, as applicable.

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

Effective Date

The amendments made by this final rule are applicable as of the first plan year beginning after April 17, 2001. This date was chosen to give the employee benefit plan community more time to comply with the new requirements. Accordingly, this change applies

to the 2001 year filings for fiscal year filers whose plan years begin after April 17, 2001, and the 2002 filings for calendar year filers.

Plan auditors should be aware that a new line, item 4k, has been added to Schedule I of the 2001 Form 5500 for plans to indicate whether they are claiming a waiver of the audit requirement.

DOL Guidance on Claims Regulation

On November 21, 2000, the DOL published in the *Federal Register* a final regulation that sets new standards for processing benefit claims of participants and beneficiaries who are covered under employee benefit plans governed by ERISA.

Help Desk—The regulation may be found at the DOL's Web site at www.dol.gov/dol/pwba.

The new claims procedure regulation began to apply to some plans for new claims filed on or after January 1, 2002. It will not begin to apply to group health plans until the first day of the first plan year beginning on or after July 1, 2002, but not later than January 1, 2003.

The claims procedure regulation changes the minimum procedural requirements for the processing of benefit claims for all employee benefit plans covered under ERISA, although the changes are minimal for pension and welfare benefit plans other than those that provide group health and disability benefits. For group health and disability benefit claims, the regulation substantially changes the procedures for benefit determinations. Among other things, it creates new procedural standards for initial and appeal-level decisions, new timeframes for decision making, and new disclosure rights for claimants.

In December 2001, in response to many questions, the DOL published new guidance, in a Q&A format, to assist plans in bringing their benefit processing systems into timely compliance with the requirements of the claims regulation. This new guidance answers many of the frequently asked questions about the application of the claims regulation to group health and disability benefit plans. To the extent that the provisions of the regulation apply to other types

of plans, the Q&A guidance applies to those plans also. The DOL anticipates providing additional guidance in the form of additional questions and answers, advisory opinions, or information letters as may be necessary to facilitate implementation of the requirements of the regulation. The views expressed in the publication represent the views of the DOL and the document may be obtained on the Internet at www.dol.gov/dol/pwba or by calling (800) 998-7542 to obtain free printed copies.

PWBA Review of Plan Audits

The PWBA has an ongoing quality review program to assess the quality of audit work performed by independent auditors in audits of plan financial statements that are required by ERISA. Practitioners deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. Because ERISA holds plan administrators responsible for assuring that plan financial statements are audited in accordance with GAAS, deficient audit work can also expose plan administrators to significant penalties under ERISA Section 502(c)(2).

The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting and disclosure requirements. The PWBA plans to conduct a nationwide study to once again assess the quality of employee benefit plan audits.

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

The PWBA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are required to be remitted as soon as they can reasonably be segregated from an employer's general assets. DOL regulations require employers who sponsor pension plans (both defined benefit and defined contribution) to remit employee contributions as soon as practicable, but in no event more than 15 business days after the month in which the participant contribution was withheld or received by the employer.

The regulation establishes a procedure by which an employer may obtain an extension of the 15 business-day limit for an additional 10 business days. This regulation does not change the maximum period for remittance of employee contributions to welfare plans; as soon as practicable, but in no event more than 90 days after the day the contribution was withheld or received by the employer.

Failure to remit or untimely remittance of participant contributions may constitute a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of credit), regardless of materiality and, in certain circumstances, may constitute embezzlement of plan assets. Additionally, such information should be properly presented on the required Form 5500 supplemental schedule of nonexempt transactions with parties-in-interest. GAAS requires that the auditor's report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules when they are presented along with the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See Chapter 11, "Party in Interest Transactions," of the Guide for further discussion of prohibited transactions.

What If You Have a Late Remittance?

If you have a late remittance, the following information should be reported on the Form 5500 Schedule G, Part III, Nonexempt Transactions:

1. The interest rate used to calculate the lost income (on line c, "Description of the transaction")
2. The amount of lost interest (included on line i, "Current value of asset")

Often there is confusion when reporting a late deposit of employee deferrals on Part III of Schedule G. As there are no precise instructions, consider completing the following items:

1. The employer is generally considered the “party involved.”
2. The relationship is the “plan sponsor.”
3. The description is “loan to employer in the form of late deposit of employee 401(k) deferrals.”
4. The current value of asset is the amount of the lost interest.
5. Other items should be left blank.

Help Desk—For questions or further information, contact the DOL Office of Regulations and Interpretations at (202) 693-8500.

PWBA Outreach and Customer Service Efforts—Contacts for ERISA Questions

The PWBA 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 PWBA’s EFAST help desk at its toll-free number, (866) 463-3278.

In addition to handling technical telephone inquiries, the PWBA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA’s reporting and disclosure requirements. This year, the DOL’s outreach efforts will feature the 2001 Form 5500, the EFAST Processing System, and other agency-related developments. Questions regarding these outreach efforts should be directed to the Office of the Chief Accountant at (202) 693-8360. Practitioners and other members of the public may also wish to contact the PWBA at its Web site at www.dol.gov/dol/pwba. The Web site also provides information on the PWBA’s organizational structure, current regulatory activities, and customer service and public outreach efforts.

Changes Made to the Delinquent Filer Voluntary Compliance Program

On March 27, 2002, the DOL announced changes to its Delinquent Filer Voluntary Correction (DFVC) program. Established in April 1995, the DFVC program was designed to encourage plan administrators to file overdue annual reports by paying reduced penalties. Over the years, the DOL received public feedback that the amount of the penalty assessments under the 1995 program, while less than the otherwise applicable penalties, was still a disincentive for many delinquent plan administrators, especially administrators of small plans. The DOL, therefore, decided to modify the program by further reducing penalties payable, and updating and simplifying the procedures governing participation in the program.

Program Eligibility

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

Program Criteria

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

New Penalty Structure

Reduced Per-Day Penalty. The basic penalty under the program was reduced from \$50 to \$10 per day for delinquent filings.

Reduced Per-Filing Cap. The maximum penalty for a single late annual report was reduced from \$2,000 to \$750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and from \$5,000 to \$2,000 for a large plan.

New Per-Plan Cap. The revised DFVC program also includes a new 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 person is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

Small Plans Sponsored by Certain Tax-Exempt Organizations. A special per-plan cap of \$750 applies to a small plan sponsored by an organization that is tax-exempt under IRC Section 501(c)(3). The \$750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if as of the date the plan files under the DFVC program, there is a delinquent annual report for a plan year during which the plan was a large plan.

Top Hat Plans and Apprenticeship and Training Plans. The penalty amount for top hat plans and apprenticeship and training plans was reduced to \$750.

Updated and Simplified Procedures

The DOL also simplified and updated the procedures governing participation in the program. The changes are intended to make the program easier to use. For example:

- Plan administrators may use the Form 5500 forms for the year relief is sought or the most current form available at the time of participation. This option allows administrators to choose the form that is most efficient and least burdensome for their circumstances.

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- The forms and penalty payment check should no longer be annotated in bold-red print identifying the filing as a DFVC filing.
 - The program has been updated to conform to the annual reporting procedures under the computerized EFAST.
 - The address where DFVC program remittances are submitted has been changed to DFVC Program, PWBA, P.O. Box 530292, Atlanta, Georgia 30353-0292. Submissions made to the old address will be returned to the filer.

IRS and PBGC Participation

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

Effective Date and Comments

The modifications of the DFVC program are effective immediately. A notice announcing the modifications was published in the *Federal Register* on March 28, 2002. PWBA is also seeking public comments on all aspects of the program. Written comments should be submitted by May 28, 2002 to:

DFVC Comments
Office of Regulations and Interpretations
Room N-5669
Pension and Welfare Benefits Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Help Desk—Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 693-8360. Practitioners and other members of the public may also wish to contact the PWBA at its Web site at www.dol.gov/dol/pwba.

Other PWBA Matters You Should Be Aware of

This section discusses the following matters:

- PWBA final rule to assist plan participants in obtaining summary plan documents (SPDs) and other plan documents.
- The Mental Health Parity Act extended to December 31, 2002.
- PWBA guidance on insurance company demutualization.
- 2001 Form M-1 for multiple employer welfare arrangements.
- The DOL Voluntary Fiduciary Correction Program.
- The PWBA orphan plan initiative.
- PWBA's Rapid ERISA Action Team (REACT) Project.

PWBA Final Rule to Assist Plan Participants in Obtaining SPDs and Other Plan Documents

On January 4, 2002, PWBA published a final rule implementing a change to ERISA that requires plan administrators to furnish to the DOL, upon request, SPDs and other documents from plan administrators on behalf of plan participants and beneficiaries.

The Taxpayer Relief Act of 1997 (TRA '97) eliminated the requirement under ERISA that employee benefit plan administrators automatically file SPDs and summaries of material modifications (SMMs) with the department. TRA '97 also added paragraph 6 to ERISA Section 104(a), providing that plan administrators furnish to the DOL, on request, any documents relating to the employee benefit plan, including but not limited to, the latest SPD (including any summaries of plan changes not contained in the SPD), and the bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated.

TRA '97 also added ERISA Section 502(c)(6) providing the secretary with the authority to assess civil penalties for a plan administrator's failure to furnish material requested under ERISA Section

104(a)(6). Specifically, ERISA Section 502(c)(6) provides that, if within 30 days of a DOL request, the plan administrator fails to furnish the requested materials, the DOL may assess a civil penalty against the administrator of up to \$100 a day from the date of such failure, but in no event in excess of \$1,000 per request. Section 502(c)(6) also provides that no penalty shall be imposed for failures resulting from matters reasonably beyond the control of the plan administrator.

Mental Health Parity Act Extended to December 31, 2002

On January 10, 2002, President Bush signed H.R. 3061 (Pub. L. 107-116, 115 Stat. 2177), the 2002 Appropriations Act for the DOL, Department of Health and Human Services (HHS), and Department of Education. This legislation included a provision that extends the original sunset date under the Mental Health Parity Act of 1996 (MHPA).

MHPA's original text included a sunset provision specifying that MHPA's provisions would not apply to benefits for services furnished on or after September 30, 2001. The amendment included as part of H.R. 3061 extends the sunset date so that MHPA's provisions will not apply to benefits for services furnished on or after December 31, 2002. The amendment to MHPA effectively extends the sunset date by 15 months.

The MHPA provisions are set forth in ERISA Section 712, Section 2705 of the Public Health Service Act, and IRC Section 9812. The MHPA applies to a group health plan (or health insurance coverage offered by issuers in connection with a group health plan) that provides medical and surgical benefits as well as mental health benefits.

The DOL, the HHS, and the Treasury (the departments) issued interim final regulations under MHPA in the *Federal Register* on December 22, 1997 (62 FR 66931). The departments are currently working on guidance concerning the extension of the MHPA's requirements provided for by the enactment of H.R. 3061.

Help Desk—For more information about mental health benefits, call the PWBA toll-free publications hotline at (800) 998-

7542 or visit the Web site at www.dol.gov/dol/pwba to obtain a free copy of *Questions and Answers: Recent Changes in Health Care Law*.

PWBA Guidance on Insurance Company Demutualization

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

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

In describing the alternatives available to policyholders of an insurance company, the DOL stated:

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

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

The letter also stated that, with respect to plans satisfying the foregoing, the DOL would not assert a violation in any enforcement proceeding or assess a civil penalty with respect to such plans because of a failure to meet the reporting requirements by reason of not coming within the limited exemptions set forth in 29 CFR 2520.104-.120 and 2520.104-.144 solely as a result of receiving an insurance company's demutualization proceeds which may be, in whole or in part, plan assets.

Help Desk—Copies of the DOL's information letter are available on the PWBA's Web site at www.dol.gov/dol/pwba/public/programs/ori/advisory2001/groomlet.htm.

2001 Form M-1 for Multiple Employer Welfare Arrangements

On December 19, 2001, the PWBA published in the *Federal Register* the 2001 Form M-1 annual report for multiple employer welfare arrangements (MEWAs) and Certain Entities Claiming Exemption (ECEs). The 2001 Form M-1 is substantially identical to the 2000 form, and the filing deadlines parallel those for last year's form. Specifically, the 2001 Form M-1 is generally due March 1, 2002, with an extension until May 1, 2002.

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

The DOL has authority under the HIPAA to require reporting of information about MEWAs. Administrators generally must file the one-page Form M-1 annually. Administrators who fail to file the Form M-1 as required are subject to penalties pursuant to DOL regulation 29 CFR 2560.502c-5; penalties can be up to \$1,000 per day, continuing up to the date that the report is filed.

Help Desk—The 2001 Form M-1 is available by calling the PWBA's toll-free publications hotline at (800) 998-7542 and is available on the Internet at www.dol.gov/dol/pwba. Administrators may contact the PWBA help desk at (202) 963-8360 for assistance in completing this form.

DOL Voluntary Fiduciary Correction Program

On March 28, 2002, the DOL announced expansions to the Voluntary Fiduciary Correction Program (VFCP) to make it easier for employers and plan officials to correct certain violations involving employee benefit plans that voluntarily comply with ERISA.

The VFCP is designed to encourage employers to voluntarily comply with ERISA by self-correcting certain violations of the law. Many workers can benefit from the program as a result of the increased retirement security associated with restoration of plan assets and payment of additional benefits. The VFCP also will help plan officials understand the law. The program describes how to apply the 14 specific transactions covered, acceptable methods for correcting violations, and examples of potential violations and corrective actions. In addition, the DOL is giving applicants immediate relief from payment of excise taxes under a proposed class exemption.

Who Is Eligible? Anyone who may be liable for fiduciary violations under ERISA, including employee benefit plan sponsors, officials, and parties-in-interest, may voluntarily apply for relief from enforcement actions, provided they comply with the criteria and satisfy the procedures outlined in the program.

Program Criteria. Persons using the program must fully and accurately correct violations. Incomplete or unacceptable applications may be rejected. If rejected, applicants may be subject to enforcement action, including assessment of civil monetary penalties under Section 502(l) of ERISA.

How to Apply. Applicants do not need to consult or negotiate with the DOL to use the program. They merely need to follow the procedures outlined in the notice published in the March 28, 2002, *Federal Register*.

Violations can be fully and correctly resolved in four easy steps:

1. Identify any violations and determine whether they fall within the transactions covered by the program.
2. Follow the process for correcting specific violations (that is, improper loans or incorrect valuation of plan assets).
3. Calculate and restore any losses and profits with interest and distribute any supplemental benefits to participants.
4. File an application with the appropriate PWBA regional office and include documentation showing evidence of corrected financial transactions.

Covered Transactions. Fourteen specific financial transactions and appropriate steps are available to fully and quickly correct any violations in the program. Corrective remedies are prescribed for the following fiduciary violations involving employee benefit plans:

- Delinquent participant contributions to pension plans
- Delinquent participant contributions to welfare plans
- Fair market interest rate loans with parties-in-interest
- Below market interest rate loans with parties-in-interest
- Below market interest rate loans with non-parties-in-interest
- Below market interest rate loans due to delay in perfecting security interest
- Purchase of assets by plans from parties-in-interest

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- Sale of assets by plans to parties-in-interest
 - Sale and leaseback of property to sponsoring employers
 - Purchase of assets from non-parties-in-interest at below market value
 - Sale of assets to non-parties-in-interest at below market value
 - Benefit payments based on improper valuation of plan assets
 - Payment of duplicate, excessive or unnecessary compensation
 - Payment of dual compensation to plan fiduciaries

Acceptable Corrections. The program provides rules for making acceptable corrections involving these transactions. Applicants must:

- Conduct valuations of plan assets using generally recognized markets for the assets or obtain written appraisal reports from qualified professionals that are based on generally accepted appraisal standards.
- Restore to the plan the principal amount involved, plus the greater of (1) lost earnings starting on the date of the loss and extending to the recovery date or (2) profits resulting from the use of the principal amount for the same period.
- Pay the expenses associated with correcting transactions, such as appraisal costs or recalculating participant account balances.
- Make supplemental distributions to former employees, beneficiaries, or alternate payees when appropriate, and provide proof of the payments.

VFCP Documentation. Under the program, applicants provide supporting documentation to the appropriate regional office of the PWBA. Documentation must include a statement showing the plan has a current fidelity bond, the name of the company providing the bond, and the policy number; a copy of relevant portions of plan and related documents; documents supporting transactions such as leases and loan documents and applicable corrections; documentation of lost earnings amounts; documentation of restored

profits; proof of payment of affected amounts; documents on affected transactions as outlined in Section 7 of the notice; a signed checklist; and a penalty of perjury statement.

Restitution Plans. Applicants must restore the plan, participants, and beneficiaries to the condition they would have been in had the breach not occurred. Plans must then file, where necessary, amended returns to reflect corrected transactions or valuations.

Under the revised program, applicants also must provide proof of payment to participants and beneficiaries or properly segregate affected assets in cases where the plan is unable to identify the location of missing individuals. Payment of the correction amount may be made directly to the plan where distributions to separated participants would be less than \$20 and the cost of correction exceeds the distributions owed. In addition, the program was modified to allow applicants to use the “blended rate” in calculating rate of return on affected transactions involving 404(c) plans only for affected participants who have not made investment allocations.

Excise Tax Exemption. In order to encourage use of the program, the DOL is proposing a class exemption providing limited relief from the excise taxes under the Internal Revenue Code imposed on transactions covered by the VFCP. The proposal would exempt from excise tax four specific transactions provided applicants comply with the conditions contained in the exemption. The exemption covers transactions involving:

- Failure to timely remit participant contributions to plans.
- Loans made at fair market interest rate by plans with parties-in-interest.
- Purchases or sales of assets between plans and parties-in-interest at fair market value.
- Sales of real property at fair market value to plans by employers and leaseback of the property at fair market rental value.

Under the exemption, applicants must repay delinquent contributions to plans no more than 180 days from the date the money was received by the employer or would have been payable to par-

ticipants in cash. The exemption also requires, except in the case of delinquent participant contributions, no more than 10 percent of the fair market value of total plan assets be involved. In addition, the exemption requires that notice of the transaction and the correction be provided to interested persons. Finally, covered transactions under the exemption cannot be part of an arrangement or understanding that benefits a related party and the exemption does not apply to any transactions for which an application for a similar transaction was submitted under the VFCP within the past three years. Applicants may use the exemption immediately even though it is currently in proposed form. Comments on the proposal or requests for a hearing were to have been submitted by May 13, 2002.

Help Desk—For additional information, applicants may contact the appropriate regional office at PWBA's toll-free employee and employer hotline number, (866) 275-7922, and request the VFCP coordinator. Questions about the proposed exemption should be directed to the Office of Exemption Determination at (202) 693-8540.

PWBA Orphan Plan Initiative

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

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

The objectives of the project are to:

- Locate orphan plans that have been abandoned by fiduciaries as a result of death, neglect, bankruptcy, or incarceration.
- Determine if the fiduciary is available to make fiduciary decisions such as the termination of the plan and the distribution of the plan assets.
- Require fiduciaries to perform their fiduciary duties, file appropriate compliance forms, and ensure that proper action is undertaken to protect and deliver promised benefits.
- Have the PWBA take an active role in the appointment of an independent fiduciary in the event that no other fiduciary is available.

The PWBA's Rapid ERISA Action Team (REACT) Project

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

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

The REACT initiative enables the PWBA to respond in an expedited manner to protect the rights and benefits of plan participants when a plan sponsor faces severe financial hardship or bankruptcy and the assets of the employee benefit plan are in jeopardy. In such situations, it is common to find employers holding assets that belong to or are owed to plans, occasionally intermingling those assets with the employers' own assets. When a plan sponsor faces severe financial hardship, the assets of any plans and the benefits of participants are placed at great risk.

Due to the tight time frames and the intricacies of the bankruptcy laws, plan assets and employee benefits are often lost because of the plan fiduciaries' failure to timely identify pension plan contributions that have not been paid to the plan's trust. REACT provides the PWBA with a dedicated staff to respond to employer bankruptcies by ensuring that all available legal actions have been taken to preserve pension plan assets.

Under REACT, when a company has declared bankruptcy the PWBA takes immediate action to ascertain whether there are plan contributions that have not been paid to the plan's trust, to advise all affected plans of the bankruptcy filing, and to provide assistance in filing proofs of claim to protect the plans, the participants, and the beneficiaries. The PWBA also attempts to identify the assets of the responsible fiduciaries and evaluate whether a lawsuit should be filed against those fiduciaries to ensure that the plans are made whole and the benefits secured.

Executive Summary—Regulatory Developments

- The 2001 Form 5500 return and reports are available and reflect changes in law, improved forms processing, and clarification of instructions.
 - New regulations have been published relating to safeguarding small pension plan assets and to set new standards for processing benefit claims.
 - The DFVC program has been modified.
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Legislative Developments

As in prior congressional sessions, the 107th Congress is likely to take up several legislative initiatives that will affect pension and health and welfare plans. Auditors should pay close attention for future legislative developments. Visit the AICPA Web site at www.aicpa.org (see the sections of the site called "Enron Crisis" and "Legislative Tracking") for a summary of Enron-related legislation, much of which may affect employee benefit plans, if enacted.

Audit Issues

Self-Directed Investments—The DOL's Alternative Method of Reporting Participant-Directed Brokerage Window Investments

Plan sponsors of participant-directed defined contribution plans continue to allow participants to expand their control over investment decisions, through self-directed investments,² sometimes referred to as self-directed brokerage accounts. These features allow participants to select any investment they choose without oversight from the plan administrator or investment committee. The only limitation is the availability of the desired investment through the plan's service provider, which generally is a securities broker-dealer or is a broker-dealer that has an alliance with the plan's service provider. The self-directed feature is often in addition to a more traditional array of risk diverse mutual funds and other investment option choices. Often plan sponsors may charge participants fees to provide this investment feature and may also require a minimum balance to be invested.

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

The issues and risks associated with self-directed features are broader than explained here and include the investment education and savvy of participants. However, ERISA Section 404(c) and

2. This is different from participant-directed investment fund options. Participant-directed investment fund options allow the participant to select from among various available alternatives and to periodically change that selection. The alternatives are usually pooled fund vehicles, such as registered investment companies (that is, mutual funds); commingled funds of banks; or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds.

proper financial reporting significantly reduce the plan's risk and financial liability associated with the investments.

The DOL's Alternative Method of Reporting Brokerage Window Investments for the 2001 Plan Year

While self-directed accounts should be viewed as individual investments for auditing and reporting purposes, the instructions to Form 5500, Schedule H, "Financial Information," have been revised for the 2001 plan year to permit aggregate reporting of certain self-directed accounts (also known as participant-directed brokerage accounts) on the Form 5500 and related schedule of assets.

For the 2001 plan year, the DOL, the PBGC, and the IRS will now allow employee benefit plans to report investments made through participant-directed brokerage accounts as a single line item on the Schedule H of the Annual Return/Report Form 5500 rather than by type of asset on the appropriate line item for the asset category (in Parts I and II of Schedule H), for example, common stocks and mutual funds, provided the assets are *not*:

- Loans
- Partnership or joint-venture interests
- Real property
- Employer securities
- Investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction

Presently, this alternative reporting feature for participant-directed brokerage account investments is available only for 2001. This recent change creates an issue with investment reporting in plan financial statements because GAAP requires certain reporting and disclosures.

The following table summarizes the differences between the 2001 Form 5500 alternative reporting for participant-directed brokerage account investments and GAAP that may raise issues for auditors when obtaining brokerage window investment information.

Form 5500—Alternative Reporting

*GAAP—Required Reporting
and Disclosures*

- Certain investments and related income (see above) made through participant-directed brokerage accounts may be shown as single line items on Schedule H.
- Identification of investments representing 5 percent or more of plan net assets in the plan's footnotes. (See paragraph 3.28g of the Guide.)
- Reporting of investment income, exclusive of changes in fair value, in the statement of changes in net assets or the footnotes. (See paragraph 3.28b of the Guide.)
- Reporting of net appreciation/depreciation by investment type in the plan's footnotes. (See paragraph 3.25a of the Guide.)

In addition, plan auditors may experience difficulty in obtaining brokerage window investment information by individual investment categories (such as common stocks and mutual funds) and brokerage window investment income (such as net appreciation/depreciation by type) from plan service providers. In plans subject to the limited scope audit provisions of ERISA, the investment certification may provide investment amounts only in total, not for the individual investments. However, brokerage window investments are not considered a fund or a pooled separate account subject to other reporting requirements. Individual investment information is needed by plan administrators and auditors for the valuation of investment assets in the plan and for audit testing and disclosure purposes in accordance with GAAP and GAAS. Therefore, it is important for plan administrators, recordkeepers, and service providers to maintain these records for audit and financial reporting purposes.

It is also important to note that the single line reporting of participant-directed brokerage window investment assets on the Form 5500 is allowed provided the investment assets are not loans, partnership or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction.

The participant-directed brokerage window investment alternative reporting feature is allowed only for the 2001 plan year. Members of the AICPA's DOL Liaison Task Force will continue to work with the DOL as they conduct a review of this alternative reporting method for plans with brokerage windows in an effort to determine whether and under what circumstances such method of reporting may need to be modified to ensure adequate information is provided to plan sponsors, participants, and beneficiaries; the DOL; the PBGC; and the IRS in the future. Also, this alternative method of reporting of participant-directed brokerage window investments does not relieve fiduciaries from their obligation to prudently select and monitor designated plan investment options and brokers.

What Are Derivatives? How Do I Audit Them?

Employee benefit plans sometimes use derivatives as tools to manage the risk stemming from fluctuations in foreign currencies, interest rates, and other market risks, or as speculative investment vehicles to enhance earnings. Derivatives get their name because they derive their value from movements in an underlying³ such as changes in the price of a security or a commodity. Examples of common derivatives are options, forwards, futures and swaps. Employee benefit plans that use derivatives to manage risk are involved in hedging activities. Hedging is a risk alteration activity that attempts to protect the employee benefit plan against the risk of adverse changes in the fair values or cash flows of assets, liabilities, or future transactions. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments in debt and equity securities, investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and derivative instruments and hedging activities. The objective of auditing procedures applied to deriva-

3. Paragraph 2.09 of the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* defines an *underlying* as a specific interest rate, security price, commodity price, foreign exchange rate, index of prices, or rates, or other variable. An underlying may be a price or rate of an asset or liability, but it is not the asset or liability itself.

tive instruments and related transactions is to provide the auditor with a reasonable basis for concluding:

1. Whether derivatives transactions are initiated in accordance with management's established policies.
2. Whether information relating to derivatives transactions is complete and accurate.
3. Whether derivatives accounted for as hedges meet the designation, documentation, and assessment requirements of generally accepted accounting principles (GAAP).
4. Whether the carrying amount of derivatives is adjusted to fair value, and changes in the fair value of derivatives are accounted for in conformity with GAAP.
5. Whether derivatives are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.

The auditing procedures to be applied to derivative instruments and hedging activities ordinarily should include:

1. Confirmation with the counterparty to the derivative
2. Confirmation of settled and unsettled transactions with the counterparty
3. Testing the fair value
4. Physically inspecting the derivative contract
5. Reading and inspecting related agreements, underlying agreements and other forms of documentation for amounts reported, unrecorded repurchase agreements, and other evidence
6. Inspecting supporting documentation for subsequent realization or settlements after the end of the reporting period
7. Reading other information, such as minutes of committee meetings
8. Testing to ensure derivative transactions are initiated in accordance with policies established by the plan's management

The unique characteristics of derivatives instruments and securities, coupled with the relative complexity of the related accounting guidance, may require auditors to obtain special skills or knowledge to plan and perform auditing procedures. SAS No. 92 is intended to alert auditors to the possible need for such skill or knowledge. Also, see the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* for further guidance on auditing such instruments (product no. 012520).

Descriptions of Certain Derivatives

Chapter 3 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* includes brief descriptions of certain financial instruments that may be helpful when such investments are used by employee benefit plans. The following is a description of some derivative financial instruments commonly found in employee benefit plans:

- *Call option*—A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price (strike price) at any time until the stated expiration date of the contract. The option, which is transferable, is bought in the expectation of a price rise above the strike price. If the price rises, the buyer exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There are both a listed and an over-the-counter market in options. During the existence of an option, the exercise price and underlying number of shares are adjusted on the exercise date for cash dividends, rights, and stock dividends or splits.
- *Forward foreign exchange contract*—An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.
- *Futures contract*—A transferable agreement to deliver or receive during a specific future month a standardized amount of a commodity of standardized minimum grade or a finan-

cial instrument of standardized specification under terms and conditions established by the designated contract market.

- *Guaranteed investment contract (GIC)*—Nontradeable contract that guarantees return of principal and a specific minimum rate of return on invested capital over the life of the contract. Many contracts also provide for withdrawals of principal at par at specified dates and/or upon specified conditions before maturity. Most frequently used by pension and retirement plans where withdrawals are permitted to fund retirement benefits, payments to employees leaving the company, or transfers of benefits among investment options.
- *Put option*—A contract entitling the holder to sell (put), at his or her option, a specified number of shares or units of a particular security at a specified price (strike price) at any time until the contract's stated expiration date. The option, which is for a round lot and is transferable, is bought on the expectation that the price will decline below the strike price. If the price declines below the strike price, the buyer exercises or sells the option. If the price does not decline below the strike price, the buyer lets the option expire and loses only the cost of the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an over-the-counter option are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.
- *Synthetic GICs*—An investment contract that simulates the performance of a traditional GIC through the use of financial instruments. (For more information regarding current accounting and financial reporting for GICs and synthetic GICs, see paragraphs 7.44 and 7.45 of the Guide.)

Health and Welfare Benefit Plan Issues—Electronic Processing of Benefit Claims and Indemnification Agreements

Electronic Processing of Benefit Claims

Providers and claim administrators have been processing and sending health and prescription drug claims electronically for years. When claims are submitted electronically, they are compared with

the system parameters which have been programmed by the claim administrator based upon the plan's specifications. If these system parameters have not been programmed correctly, the claim may not be accurately processed.

Auditors should gain an understanding of the internal control surrounding the processing and payment of claims. Generally, the claims administrator is authorized by the plan to initiate, execute, and account for the processing of electronic claims without specific authorization of the transactions. There is a lower degree of interaction and it may not be practicable for the plan to implement effective controls over these transactions. The auditor may not be able to obtain an understanding of the components of internal control, relevant to such transactions, sufficient to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those components of internal control maintained by the claims administrator. This understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70, *Service Organizations*, as amended,⁴ for the claims administrator. If the SAS No. 70 report is unavailable, the auditor should consider other appropriate procedures to obtain sufficient evidence to achieve the audit objectives. For example, the engagement team should consider information available at the sponsor level about the controls at the claims administrator, including user manuals, system overviews, technical manuals, and reports from the claims administrator's internal auditors. The auditor may determine that it is necessary to conduct tests of the claims administrator's systems and procedures.

In addition to the above, the auditor should consider testing the eligibility data supplied to the claims administrator and review the accuracy of the system parameters (that is, see that the deductible or copayment level, coinsurance, internal maximums, and so on, are in accordance with the plan specifications). The system parameters should also verify that referral or authorization procedure, and negotiated fee arrangements with providers are followed.

4. The AICPA Audit and Attest Standards Team has made conforming changes to SAS No. 70 to reflect the issuance of SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*.

Confidentiality or Indemnification Agreements

As noted earlier, in response to the new HIPAA regulations (see the section “The Health Insurance Portability and Accountability Act” in this Alert) claim processors may be updating and instituting a variety of confidentiality or indemnification agreements to protect the organization when third parties request claim information. Many third-party administrators that process health and welfare claims for plan administrators do not have a report on their internal control prepared in accordance with SAS No. 70, as amended.⁵ In these instances it may be necessary for the auditor to request access to the third-party administrator’s records to test claim transactions in order to obtain sufficient evidence to achieve the audit objectives. In many instances, a third-party administrator will request that the auditor enter into a confidentiality or indemnification agreement signed by the auditor, third-party administrator, and plan sponsor relating to the claims testing. Auditors need to take special care in reviewing these agreements. Often the auditor may not agree with certain language in the agreement, resulting in delays in the audit while mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. Auditors need to keep in mind that the testing of claims at a third-party administrator could be delayed as a result of the request to sign such an agreement and should plan the timing of the audit accordingly. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor’s legal counsel. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, a scope limitation could result.

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5. Same as footnote 4.

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

The AICPA, working with the PWBA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans, and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of license. Some common recurring deficiencies noted by the AICPA Peer Review Board⁶ in its review of employee benefit plans include:

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

6. Taken from the *AICPA 2000/2001 Peer Review Board Oversight Task Force Report and Comments*.

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

Executive Summary—Audit Issues

- For 2001, employee benefit plans may report certain investments made through participant-directed brokerage accounts as a single line item on Schedule H of the Form 5500. This raises issues for auditors.
 - Health and prescription drug claims are typically processed electronically, which makes auditing these claims more difficult.
 - Third-party administrators continue to request that auditors enter into confidentiality or indemnification agreements.
 - SAS No. 92 provides guidance on auditing procedures to be applied to derivative instruments and hedging activities.
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New Auditing and Attestation Pronouncements and Guidance

Presented below is a list of auditing and attestation pronouncements, Guides, and other guidance issued since the publication of last year's Alert.

Help Desk—For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter *In Our Opinion* issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 150)
SAS No. 96	<i>Audit Documentation</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 339)
SOP 01-3	<i>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</i>

SOP 01-4	<i>Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards</i>
SSAE No. 11	<i>Attest Documentation (AICPA, Professional Standards, vol. 1, AT secs. 101–701)</i>
Audit Guide	<i>Service Organizations; Applying SAS No. 70, as Amended</i>
Audit Guide	<i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>
Audit Guide	<i>Auditing Revenue in Certain Industries</i>
Audit Guide	<i>Audit Sampling</i>
Audit Guide	<i>Analytical Procedures</i>
Auditing Interpretation ⁷ No. 1 of SAS No. 73	“The Use of Legal Interpretations As Evidential Matter to Support Management’s Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140,” of SAS No. 73, <i>Using the Work of a Specialist (AICPA, Professional Standards, vol. 1, AU sec. 9336.01–.21)</i>
Interpretation No. 14 of SAS No. 58	“Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing,” of SAS No. 58, <i>Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508.56–.59)</i>
Interpretations of SAS No. 70, <i>Service Organizations</i> , as amended	<ul style="list-style-type: none"> • Interpretation No. 4, “Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization’s Description of Controls,” of SAS No. 70 (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 9324.35–.37)

(continued)

7. Auditing Interpretations are issued by the Audit Issues Task Force of the ASB to provide timely guidance on the application of auditing pronouncements. Interpretations are an *interpretive publication* pursuant to SAS No. 95, *Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1, AU sec. 150)*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

	<ul style="list-style-type: none"> • Interpretation No. 5, “Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods,” of SAS No. 70 (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 324.38–40) • Interpretation No. 6, “Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor’s Engagement,” of SAS No. 70 (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 9324.40–42)
Practice Alert 01-1	<i>Common Peer Review Recommendations</i>
Practice Alert 01-2	<i>Audit Considerations in Times of Economic Uncertainty</i>
Practice Alert 02-1	<i>Communications with the Securities and Exchange Commission</i>

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards. To obtain copies of AICPA standards and Guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 95, *Generally Accepted Auditing Standards*

SAS No. 95, *Generally Accepted Auditing Standards*, supersedes SAS No. 1, section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). This SAS creates a hierarchy of GAAS. It also:

- Identifies the body of auditing literature
- Clarifies the authority of auditing publications issued by the AICPA and others
- Specifies which auditing publications the auditor must comply with and which ones the auditor must consider when conducting an audit in accordance with GAAS
- Identifies specific AICPA auditing publications and provides information on how to obtain them

SAS No. 96, *Audit Documentation*

This SAS supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and amends several other

SASs. It presents revised guidance regarding the objective, nature, and extent of documentation required for compliance with SASs. SAS No. 96 is effective for financial statements for periods beginning on or after May 15, 2002 (early application is permitted).

The auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

Audit documentation serves mainly to:

1. Provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to GAAS.⁸
2. Aid the auditor in the conduct and supervision of the audit.

Examples of audit documentation are audit programs,⁹ analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents,¹⁰ and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.

Audit documentation should be sufficient to (1) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing proce-

8. However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

9. See SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.05), for guidance regarding preparation of audit programs.

10. Audit documentation should include abstracts or copies of significant contracts or agreements that were examined to evaluate the accounting for significant transactions. Additionally, audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested.

dures performed, and the evidence obtained;¹¹ (2) indicate the engagement team member(s) who performed and reviewed the work; and (3) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

In addition to these requirements, SAS No. 96 provides further requirements about the content, ownership, and confidentiality of audit documentation. Moreover, Appendix A to SAS No. 96 lists the audit documentation requirements contained in other statements on auditing standards.

Audit Guide, *Service Organizations: Applying SAS No. 70, as Amended*

The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* is designed to provide guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements.

The new Guide also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70, *Service Organizations*, as amended. This Guide also provides guidance on the use of subservice organizations.

Help Desk—This Guide was initially issued as an Auditing Procedure Study titled *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*. In 1998, it was reissued as an Auditing Practice Release and was revised to incorporate the guidance in SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. SAS No. 78 revises the definition and description of

11. A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*, vol. 1, AU sec. 161].)

internal control contained in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, to recognize the definition and description contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. This version of the document is an Audit Guide. It has been revised to reflect the issuance of SAS No. 88, *Service Organizations and Reporting on Consistency*, which clarifies the applicability of SAS No. 70. It also reflects the paragraph renumbering in SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*. SAS No. 94 amends SAS No. 55 to provide guidance to auditors about the effect of information technology on internal control, and on the auditor's understanding of internal control and assessment of control risk.

Accounting Developments

SOP 01-2 Issues

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

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

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- Requires disclosure of the discount rate used for measuring the plan's obligation for postemployment benefits.
 - Requires the identification of investments representing 5 percent or more of the net assets available for benefits.

This SOP is effective for financial statements for plan years beginning after December 15, 2000, with earlier application encouraged. Financial statements presented for prior plan years are required to be restated to comply with the provisions of this SOP.

Obligation Measurement Date Different From Financial Statement Date

SOP 01-02 requires the obligation measurement date to be as of the financial statement date. Often valuations for postretirement obligations prepared for plan sponsor financial statements under FASB Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, may have a measurement date within the last quarter of the year. Does this mean the valuation prepared for FASB Statement No. 106 purposes will not work for employee benefit plan financial statements if a measurement date earlier than the financial statement date was used in the valuation? No, the obligation in the FASB Statement No. 106 valuation would need to be rolled forward to the financial statement date, in accordance with paragraph 15 of SOP 01-02.

Securities Lending Activities

Securities custodians commonly carry out securities lending activities on behalf of their employee benefit plan clients. The borrowers of securities generally are required to provide collateral to the lender (the plan). This collateral is typically cash but sometimes it may be other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the borrower. If the collateral is other than cash, the lender typically receives a fee. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides ac-

counting and reporting guidance for transfers of financial assets, including accounting for securities lending activities. FASB Statement No. 140 addresses:

- Whether the transaction is a sale of the loaned securities for financial reporting purposes
- If the transaction is not a sale, how the lender should report the loaned securities
- Whether and how the lender should report the collateral
- How the lender should record income earned as a result of securities lending transactions.

If the securities lending transaction includes an agreement that entitles and obligates the plan (the transferor) to repurchase the transferred securities under which the plan maintains effective control over those securities, then the plan must account for those transactions as secured borrowings (not sales) and continue to report the securities on the statement of net assets. However, the securities loaned generally should be reclassified and reported separately from other assets not so encumbered pursuant to paragraph 15(a) of FASB Statement No. 140. The plan should record the cash collateral received as an asset—and any investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (considered the amount borrowed).

Generally, if the plan receives securities (instead of cash) that may be sold or repledged, the plan accounts for those securities in the same way as it would account for cash received. That is, the plan recognizes in the statement of net assets the securities received as collateral and the obligation to return that collateral. Since paragraph 94 of FASB Statement No. 140 requires that only the lender recognize securities collateral received in its statement of net assets, it is important to accurately identify the lender and borrower in securities lending transactions. One indicator that the plan is the lender is that the collateral received by the lender generally has a value slightly higher (for example, 2 percent) than that of the securities being borrowed.

The interest income earned and rebate interest paid as a result of securities lending activity should be recorded on the statement of changes in net assets available for benefits.

FASB Issues Statement 133 Implementation Guidance for Employee Benefit Plan Contracts

Since the issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, questions have been raised regarding the proper accounting for such contracts as insurance contracts, guaranteed investment contracts (GICs), and synthetic GICs that are held by various defined contribution pension and health and welfare plans.

FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to require defined benefit plans to report insurance contracts “in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA” (that is, at either fair value or contract value). SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, indicates that a fully benefit-responsive investment contract should be reported at contract value and provides an example of a fully benefit-responsive synthetic GIC as an investment contract that is subject to SOP 94-4.

A potential conflict with FASB Statement No. 133 arises because for some insurance contracts with embedded derivatives, FASB Statement No. 133 requires that the insurance contract be bifurcated and the embedded derivative be accounted for separately (that is, at fair value). In addition, Statement 133 Implementation Issue No. A16, “Synthetic Guaranteed Investment Contracts,” which was cleared in March 2001, concludes that synthetic GICs meet FASB Statement No. 133’s definition of a derivative instrument from the perspective of the issuer. Since FASB Statement No. 133’s definition applies to the terms of the contract, that conclusion also implies that synthetic GICs meet the definition of a derivative from the viewpoint of the holder. A potential conflict arises because FASB Statement No. 133 does

not contain an exception for synthetic GICs held by reporting entities subject to SOP 94-4.

To address this issue, the FASB issued Statement 133 Implementation Issue No. C19, “Contracts Subject to Statement 35, Statement 110, or Statement of Position 94-4,” in October 2001. This guidance provides for contracts that are accounted for under either FASB Statement No. 110 or FASB Statement No. 35, as amended by FASB Statement No. 110, are not subject to FASB Statement No. 133. Similarly, a contract that is accounted for under SOP 94-4 is not subject to FASB Statement No. 133. However, this scope exception does not apply to the contract’s counterparty that does not account for the contract under FASB Statement No. 35, FASB Statement No. 110, or SOP 94-4.

This guidance is tentative until it is formally cleared by the FASB and incorporated in a FASB staff implementation guide, which is contingent upon an amendment of Statement 133 being issued. The FASB intends to issue an exposure draft proposing an amendment of Statement 133. More information relating to this issue can be found on FASB’s Web site at www.fasb.org/tech/index.html.

Accounting Pronouncements and Guidance Update

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year’s alert.

Help Desk—For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	<i>Business Combinations</i>
FASB Statement No. 142	<i>Goodwill and Other Intangible Assets</i>
FASB Statement No. 143	<i>Accounting for Asset Retirement Obligations</i>
FASB Statement No. 144	<i>Accounting for the Impairment or Disposal of Long-Lived Assets</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>

(continued)

SOP 00-3	<i>Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts</i>
SOP 01-1	<i>Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools</i>
SOP 01-2	<i>Accounting and Reporting by Health and Welfare Benefit Plans</i>
AICPA Audit and Accounting Guide	<i>Audits of Investment Companies (With Conforming Changes as of May 1, 2001)</i>
Questions and Answers	<i>FASB Statement No. 140</i>

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org.

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Statement No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This Statement supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in that Opinion). This Statement also amends Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged.

Audit and Accounting Guide Revisions as of May 1, 2002

The following list summarizes some of the revisions that will be included in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), with conforming changes as of May 1, 2002.

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

- SOP O1-2, *Accounting and Reporting by Health and Welfare Benefit Plans*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, including conforming changes made to SAS No. 70, *Service Organizations*
- SAS No. 96, *Audit Documentation*
- The new AICPA Audit Guide, *Service Organizations: Applying SAS No. 70, as Amended*

The Guide also provides guidance on accounting for securities lending transactions and auditing derivative instruments, and includes an expanded Exhibit G-1, *Summary of Objectives, Procedures, and Other Considerations for Auditing Investments* to include participant loans, derivatives, and other investments.

Help Desk—To order this Guide, see the “Member Satisfaction Center” section of this Alert (product no. 012592kk).

AICPA Professional Ethics Division Interpretations and Rulings

AICPA Independence Rule Modernization—Spotlight on the Engagement Team and Those Who Influence the Engagement Team

In light of fast-moving changes in society and business, the profession has responded by shifting from “firm based” independence rules toward an approach that is “engagement team based.” In an effort to modernize the profession’s rules on independence, the Professional Ethics Executive Committee (PEEC) of the AICPA approved new independence rules on August 9, 2001. The rules become effective May 31, 2002. These significant revisions to the AICPA Code of Professional Conduct Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101), seek to modernize and harmonize independence rules with those of other governing bodies, most notably the SEC, while simplifying the rules at the same time. See the general *Audit Risk Alert—2001/02* for a summary of these new rules.

Help Desk—You should familiarize yourself with the new independence rules. Final rules are available at www.aicpa.org/members/div/ethics/adopt.htm and were published in the November 2001 issue of the *Journal of Accountancy*.

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

Help Desk—It is important for you to monitor the activities of the Professional Ethics Executive Committee because it may issue Interpretations, ethics rulings, or both, that may be relevant to your engagements. For full information about Interpretations and rulings, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077,

menu option 2, followed by menu option 2. It is important to point out that, for ERISA engagements, the DOL has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.85 in Appendix A of the Guide for a listing of the DOL's independence standards.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA general *Audit Risk Alert—2001/02* summarizes some of the more significant exposure drafts outstanding.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including a downloadable copy of the exposure draft.

<i>Standard-Setting Body</i>	<i>Web site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

The Auditing Standards Board (ASB) is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that are expected to be proposed include:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

In connection with this major initiative, the ASB and the International Auditing Practices Committee (IAPC) have agreed to form a joint task force to develop a joint standard addressing the risk

assessment process. This standard will represent a significant step toward converging U.S. and international auditing standards. The standards produced by this joint task force will form the basis for the ASB's overall project.

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

Exposure Draft on New Fraud Standard

In February 2002 the AICPA's Auditing Standards Board issued an exposure draft of a proposed statement on auditing standards, *Consideration of Fraud in a Financial Statement Audit*. This proposed SAS establishes standards and provides guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with GAAS. A copy of this exposure draft can be obtained on the AICPA's Web site at www.aicpa.org.

International Accounting Standards

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

Employee Benefit Plan-Related Standards

The following are employee benefit plan-related standards:

- International Accounting Standard (IAS) No. 19, *Employee Benefits*, addresses postemployment benefits including pensions.
- IAS No. 26, *Accounting and Reporting by Retirement Benefit Plans*, addresses the accounting and reporting by retirement benefit plans. It establishes separate standards for reporting by defined benefit plans and by defined contribution plans.

In February 2002 the IASC issued an exposure draft that would amend IAS No. 19. For a summary or to download a copy of the exposure draft, visit the IASC Web site.

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

Resource Central

Related Publications

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

- AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of May 1, 2002 (product no. 012592kk).
- AICPA Practice Aid Series, including:
 - *Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans*, second edition (product no. 006608kk). Offering the same kind of powerful help that the AICPA's *Accounting Trends & Techniques* does, this comprehensive Practice Aid illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The Practice Aid includes SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, and SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*, and the new Form 5500 schedules.
 - *Auditing Multiemployer Plans* (product no. 006603kk). This publication provides guidance on unique issues regarding the accounting, auditing, and reporting on financial statements of various types of multiemployer employee benefit plans. This nonauthoritative Practice Aid is designed to complement the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

There are chapters on SOP 92-6 application, investments, employer payroll audits, internal control testing, and more. Also included are illustrative financial statements for various types of multiemployer employee benefit plans.

- Checklists and Illustrative Financial Statements for:
 - *Defined Benefit Pension Plans* (008776kk). The 2002 checklist will be available this summer (product no. 008789kk).
 - *Defined Contribution Pension Plans* (008777kk). The 2002 checklist will be available this summer (product no. 008790kk).
 - *Health and Welfare Benefit Plans* (008778kk). The 2002 checklist will be available this summer (product no. 008791kk).
- “A Wake-Up Call,” an employee benefit plan audit video (013801kk).

CD-ROM

The AICPA is currently offering a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Conferences

National Conference on Employee Benefit Plans

Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and industry or plan sponsors on various topics including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2003 National Conference on Employee Ben-

efit Plans will be held May 5-7, 2003, in San Antonio, Texas. For a conference brochure, please call (888) 777-7077, and request brochure G50038, or for more information, visit the Web site www.cpa2biz.com/conferences.

Education Courses

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

- *Audits of Employee Benefit Plans*
- *Auditing Benefit Plans: Selected Topics*
- *Audits of 401(k) Plans*

Online CPE

The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

The Practitioner's Update (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

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

Hotlines

Accounting and Auditing Technical Hotline

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

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz

This is the product of an independently incorporated joint venture between the AICPA and state societies. It currently offers a broad array of traditional and new products, services, communities, and capabilities so CPAs can better serve their clients and employers. Because it functions as a gateway to various professional and commercial online resources, www.cpa2biz.com is considered a Web "portal."

Some features CPA2Biz provides or will provide include:

- Online access to AICPA products such as Audit and Accounting Guides, and Audit Risk Alerts
- News feeds each user can customize
- CPA "communities"
- Online CPE
- Web site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online

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- Links to a wider variety of professional literature
 - Advanced professional research tools

Other Helpful Web Sites

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

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This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2001*.

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

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APPENDIX A

IRS Limits on Benefits and Compensation

	<i>2002</i>	<i>2001</i>	<i>2000</i>
Defined benefit			
Maximum annual pension	\$160,000	\$140,000	\$135,000
Defined contribution			
Maximum annual addition	\$40,000 ¹	\$35,000	\$30,000
401(k) plan			
Maximum elective deferral	\$11,000 ²	\$10,500	\$10,500
403(b) plan			
Maximum elective deferral	\$11,000	\$10,500	\$10,500
457 plans	\$11,000	\$8,500	\$8,000
SIMPLE plans	\$7,000	\$6,500	\$6,000
Qualified plans			
Maximum compensation limits	\$200,000	\$170,000	\$170,000
Highly compensated limits	\$90,000	\$85,000	\$85,000
Officer limits (key employee)	\$130,000	\$70,000	\$67,500
FICA taxable wage base	\$84,900	\$80,400	\$76,200
Employer and employee			
Social Security tax	6.20%	6.20%	6.20%

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1. The limitation for defined contribution plans is increased from \$35,000 to \$40,000 effective for limitation years beginning after December 31, 2001. However, the limitation for defined contribution plans with non-calendar limitation years beginning before January 1, 2002, and ending after December 31, 2002, remains unchanged at \$35,000.
 2. See Appendix C for a summary of major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001. These changes include catch-up contributions for individuals over age 50.
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Commonly Asked Questions and Answers

The following questions and answers have been developed by the members of the 2002 Employee Benefit Plans Audit Guide Revision Task Force. They include frequently asked questions encountered by the task force members on accounting, auditing, and regulatory matters.

- Q.** Can the plan sponsor accept a certification from the plan's recordkeeper if the recordkeeper certifies the investment information to be complete and accurate on behalf of the Plan's trustee/custodian as "agent for"?
- A.** According to the DOL, such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee's behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited scope report to include reference to such an arrangement. Sample language might include the following: "any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan. . . . We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate." The third paragraph of the report should also be modified.
- Q.** Is it permissible to perform a limited scope audit on a portion of the plan's investments but not all (some investments did not

meet the DOL 29 CFR 2520.103-8 criteria for a limited scope audit)? If yes, what form does the auditors' report take?

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

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

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

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

A. An audit generally is required if the plan is covered under Title I of ERISA and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in Chapter 5 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of May 1, 2002 (the Guide) provides guidance on determining who is considered a participant. In addition, U.S. Department of Labor (DOL)

regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category (“large plan” or “small plan”) as was filed in the previous year.

- Q.** What audit procedures should be performed on material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?
- A.** If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance transferred from the prior plan financial statements reconciles to the balance that is reflected on the new plan’s financial statements. Also, the auditor will generally perform procedures to ensure that a sample of participant accounts were properly set up under the new plan. In addition to the participant level testing, if the prior plan was not audited, the auditor will generally perform audit procedures to determine that the equity that is transferred from the prior plan is reasonable based upon an analysis of historical activity. (Other audit procedures relating to plan mergers can be found in paragraphs 12.11 through 12.14 of the Guide)
- Q.** When a plan operates in a decentralized environment, what additional audit procedures should be considered?
- A.** The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.
- Q.** When the majority of a plan’s assets are held in a master trust, but the plan has investments outside of the master trust, what are the requirements for the supplemental schedules?
- A.** The Form 5500 instructions exclude master trust assets from the supplemental schedule reporting requirements. However, any assets held outside the master trust must be reported on the supplemental schedules. When calculating the 5 percent threshold for disclosing reportable transactions,

the current value of master trust assets is subtracted from the beginning of the year net asset balance.

Q. Is the master trust required to be audited?

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

Q. Is a certification at the master trust level acceptable under DOL regulation 2520.103-8?

A. If a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, the DOL requires separate individual plan certifications from the trustee or the custodian regarding the allocation of the assets and the related income activity to the specific plan.

Q. Should noninterest-bearing cash be included as an asset on the supplemental schedule of assets (held at end of year)?

A. Generally, only assets held for investment are included on the supplemental schedule of assets (held at end of year); thus noninterest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.

Q. Can immaterial investments be netted together as "other" on the supplemental schedule of assets (held at end of year)?

A. No, each investment must be separately listed on the supplemental schedule.

Q. What is the auditor's responsibility for detecting nonexempt transactions resulting from participant contributions that are not remitted to the plan within the guidelines established by DOL regulations?

A. An audit performed in accordance with generally accepted auditing standards (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, during the audit the auditor should be aware of

the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire about the existence of any party-in-interest or nonexempt transactions. If any issues relating to late remittances are brought to the auditor's attention, the auditor may consider obtaining a schedule of employee contributions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.

- Q.** If a nonexempt transaction related to the above is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of nonexempt transactions?
- A.** There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.
- Q.** When is a plan subject to the requirements of the Securities and Exchange Act of 1933, thus requiring a Form 11-K filing under the Securities and Exchange Act of 1934?
- A.** Section 3(a)(2) of the Securities and Exchange Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements, provided they are both voluntary and contributory. (For further guidance, see paragraph 12.21 of the Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.
- Q.** In a defined contribution plan, can investments be shown as a one-line item on the financial statements?
- A.** Participant-directed plan investments may be shown in the aggregate, as a one-line item in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as reg-

istered investments companies, government securities, corporate bonds, common stocks, and so on.

- Q.** If investments are shown as a one-line item in a defined contribution plan, what disclosures are required?
- A.** The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise. Investments that represent 5 percent or more of the net assets available for benefits should be separately identified. If any of those investments are nonparticipant-directed, they should be identified as such. Listing all investments in the schedule of assets (held at end of year) required by the Employee Retirement Income Security Act of 1974 (ERISA) does not eliminate the requirement to include this disclosure in the financial statements.
- Q.** Are participant loans considered an investment on the face of the financial statements or as a loan receivable?
- A.** Loans are considered an investment for reporting purposes.
- Q.** Should the benefits paid per the statement of changes in net assets available for plan benefits agree to the benefits paid in the statement of changes in accumulated plan benefits for a defined benefit pension plan?
- A.** The benefits paid should be the same on both statements. If differences are noted, the auditor should resolve the issue with the actuary to determine if the actuarial number requires adjustment.
- Q.** Is the schedule of 5 percent reportable transactions required for defined benefit plans?
- A.** As defined benefit plans generally are not participant-directed, the reportable transactions schedule would be required.
- Q.** When does a health and welfare plan require an audit?
- A.** A health and welfare plan is required to have an audit when the plan has more than 100 participants at the beginning of the plan year (this can be expanded to 120 if the 80-to-120-participant rule applies) and the plan is funded. According to DOL Regulation 2520.104-44, the existence of a separate fund or account for the plan by the employer or a third-party

administrator (TPA) can cause the requirement that funds be paid directly from the general assets of the sponsor not to be met. For example, if a separate account is maintained that would be deemed to be a trust under state law, the related plan would be deemed to be funded under ERISA. It is not always easy to determine when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, or the DOL to determine if a plan meets the definition of funded.

- Q.** Are participants counted the same way for pension plans and health and welfare benefit plans?
- A.** Participants for health and welfare plans are employees who are eligible and are receiving coverage under the plan.
- Q.** If participants are contributing toward the health and welfare benefits, is an audit required?
- A.** According to DOL Technical Releases 88-1 and 92-1, participant contributions to a welfare plan that has an IRC Section 125 cafeteria plan feature do not have to be held in trust. If contributions are not through a Section 125 plan and they are not used for the payment of insurance or health maintenance organization (HMO) premiums, generally, they will be required to be held in trust. If the plan is funded voluntarily or as required by DOL regulation, then the plan would require an audit.
- Q.** If a plan offers several benefits under the plan document, and only medical is funded through the voluntary employees' beneficiary association (VEBA) trust, what is the audit requirement?
- A.** The audit requirement is of the plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.
- Q.** If a VEBA trust is used as a pass-through for claims payment during the year, but there are no monies in the VEBA trust at year end, is an audit of the plan required?
- A.** If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.

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- Q.** If multiple plans use a VEBA trust, can an audit be performed at the VEBA trust level?
- A.** The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.
- Q.** Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?
- A.** If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.

APPENDIX C

Summary of Major Retirement Plan Law Changes

The following table summarizes the major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001.

Summary of Major Retirement Plan Law Changes

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
1	Increased IRA contribution limits IRC § 219	The current \$2,000 contribution limit is increased for traditional and Roth IRAs to \$3,000 beginning in 2002, then to \$4,000 in 2005, and \$5,000 in 2008. After 2008, the limit will be adjusted for inflation.	2002	601
2	Catch-up IRA contributions for individuals over 50 IRC § 219	Individuals who are at least age 50 by the end of the tax year can increase their normal IRA contribution limit by \$500 per year for 2002–2005 and \$1,000 for 2006 and later. Thus, for example, such an individual's total limit in 2002 will be \$3,500 (\$3,000 regular limit plus the special over 50 limit of \$500).	2002	601
3	Increased benefit and contribution limits for qualified plans IRC §§ 401(a)(17) and 415	<p>New law limits:</p> <ul style="list-style-type: none"> • Section 415(b)(1)(A) limit on annual benefits from a defined benefit plan will be \$160,000. • Section 415(c)(1) limit on annual additions to a defined contribution plan is raised from \$35,000 to \$40,000. • Section 401(a)(17) limit on compensation for plan purposes is raised from the current \$170,000 to \$200,000. <p>All three new limits will be indexed for inflation after July 1, 2001.</p>	<ul style="list-style-type: none"> • Years ending after 2001 • Years beginning after 2001 • Years beginning after 2001 	611
4	Elective deferrals IRC § 402(g)	The current \$10,500 limit on elective deferrals is increased to \$11,000 in 2002 and then by \$1,000 each year until it reaches \$15,000 in 2006.	2002	611

Summary of Major Retirement Plan Law Changes (continued)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
5	Elective deferrals to SIMPLE plans IRC § 408(p)(2)	The current \$6,500 SIMPLE retirement account limit is increased to \$7,000 in 2002 and then by \$1,000 each year until it reaches \$10,000 in 2005.	2002	611
6	Plan loans for owner employees IRC § 4975(f)(6)	The special restrictions under current law on plan loans to owner employees is generally eliminated. This will allow for loans to sole proprietors, more-than-10% partners, and more-than-5% Sub-S shareholders under the same rules as for other employees. Present law restrictions will continue to prohibit loans from IRAs, including SEPs and SIMPLE IRAs.	2002	612
7	Top-heavy provisions IRC § 416(i)	The top-heavy rules are changed: Three changes have been made to the definition of <i>key employee</i> : (1) The determination will be based solely on the participant's status and compensation in the plan year containing the determination date (the preceding 4 years will no longer be considered), (2) an officer is treated as a key employee based on officer status only if the employee earns more than \$130,000, and (3) the "top 10 owner" category has been eliminated. Matching contributions will now count toward satisfying the top-heavy minimums. The matching contribution of a safe harbor 401(k) plan will be deemed to satisfy the top-heavy rules. This does not mean that the match will automatically satisfy top-heavy rules for an accompanying profit-sharing plan, although the matching contributions will count toward otherwise satisfying the minimum. The 5-year look-back rule applicable to distributions will be shortened to one year for distributions other than in-service distributions.	2002	613

(continued)

Summary of Major Retirement Plan Law Changes (continued)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		A frozen top-heavy defined benefit plan will no longer be required to make minimum accruals on behalf of non-key employees.		
8	Elective deferrals and employer deduction limits IRC § 404(n)	Elective deferrals will no longer be considered employer contributions for purposes of the IRC § 404 deduction limits.	2002	614
9	Deduction limit definition of compensation IRC § 404(a)(3)(A)	The definition of compensation for purpose of the deduction limit rules will include salary reduction amounts treated as compensation under IRC § 415 (e.g., 401(k) plan elective deferrals).	2002	616
10	Profit-sharing and stock bonus plan deduction limit increased IRC § 404(a)	The annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purpose of the deduction rules.	2002	616
11	Option to treat elective deferrals as Roth contributions IRC § 402A	Effective for tax years beginning after 2005, the Act allows participants in certain plans to make after tax deferrals treated as Roth contributions.	Effective for years beginning after 2005	617
12	Tax credit for contributions IRC § 25B	From 2002 through 2006, eligible taxpayers will receive a nonrefundable tax credit of up to 50% of contributions made to an IRA 401(k), 403(b), SIMPLE, SEP, or 457 plan. This credit is available on the first \$2,000 of contributions (reduced by certain distributions) and is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The amount of the credit is determined by the adjusted gross income (AGI). For a joint filer with an AGI between \$0-\$30,000, the credit rate is 50%. The rate decreases to 20%	2002	618

Summary of Major Retirement Plan Law Changes (continued)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		when the AGI exceeds \$30,000 and then to 10% when the AGI exceeds \$32,500; it finally phases out at AGI of \$50,000.		
13	Credit for new retirement plan expenses IRC § 45E	Effective for plans established after December 31, 2001, in tax years beginning after that date, the Act provides a nonrefundable income tax credit for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan, a SIMPLE plan, or SEP. The credit applies to 50% of the first \$1,000 of qualified expenses for each of the first three years of the plan. The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. For an employer to be eligible for the credit, the plan must cover at least one non-highly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months. The 50% of qualifying expenses offset by the credit are not deductible. However, the other 50% of such expenses (along with other expenses above the \$1,000 limit) are deductible to the extent permitted under present law.	2002	619
14	Catch-up contributions IRC § 414(v)	A plan may allow individuals who have attained age 50 by year end to make catch-up contributions. The otherwise applicable dollar limit on elective deferrals under a Section 401(k) or Section 457 plan, Section 403(b) annuity, SEP, or SIMPLE is increased. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, they aren't subject to	2002	631

(continued)

Summary of Major Retirement Plan Law Changes (continued)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		<p>applicable nondiscrimination rules. However, they must be available to all participants over age 50 on an equal basis.</p> <p>An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.</p> <p>The allowable catch-up contribution applicable to 401(k), 403(b), SEP, and 457 for 2002 is \$1,000. This amount is increased by \$1,000 each year until it reaches \$5,000 in 2006.</p> <p>For SIMPLE IRA and 401(k) plans, the amount for 2002 is \$500 and is increased \$500 each year until it reaches \$2,500 in 2006.</p>		
15	Increased annual additions limit for defined contribution plans IRC § 415(c)(1)	The annual additions limit is increased from 25% of compensation under a defined contribution plan to 100% of compensation.	2002	632
16	Rollovers among various types of plans IRC §§ 402, 403, 408, 457, and 3401	Generally distributions from a qualified retirement plan. Section 403(b) annuity, IRA, or Section 457 plan can be rolled over to any of such plans or arrangements.	2002	641–643
17	Vesting IRC § 411(a)	Employer matching contributions must vest under a maximum 3-year cliff or 6-year graded vesting schedule.	Generally effective for plan years beginning after 2001	633
18	Waiver of 60-day rollover rule	The IRS may waive the 60-day rollover period if the failure to provide a waiver would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.	2002	644
19	Employer-provided retirement advice IRC § 132	Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludible from income and wages.	2002	665

Summary of Major Retirement Plan Law Changes (continued)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		The benefit must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.	2002	665
20	Deemed IRAs under employer plans IRC § 408	A qualified employer plan may elect to allow employees to make traditional or Roth IRA-type contributions to the plan.	Years beginning after December 31, 2002	602
21	Elimination of user fee for determination letter requests for small employers	User fees will be eliminated for determination letters requested by small employers within 5 years of the adoption of a new plan or within 5 years of the end of a remedial amendment period beginning in the first 5 years the plan is in existence.	2002	620
22	Multiple-use test IRC § 401(m)	The multiple use of the alternative limit test has been repealed. Employers may use the alternative limit to pass both the ADP and the ACP tests.	2002	666

Governmental Employee Benefit Plans

Governmental Employee Benefit Plans

This section has been added to address audit and accounting issues unique to governmental employee benefit plans (governmental plans). Auditors of governmental plans should also see the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, and the AICPA Audit Risk Alert *State and Local Governmental Developments*.

Help Desk—To order AICPA products, see the “Resource Central” section of this Alert.

The accounting for many governmental plans is prescribed by Governmental Accounting Standards Board (GASB) standards, primarily Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The AICPA Audit and Accounting Guide *Audit of Employee Benefit Plans* (the Guide) and related AICPA publications (such as this Audit Risk Alert, the checklists, and Practice Aids listed in the “Related Publications” section of this Alert) are designed to address issues related to plans sponsored by commercial or not-for-profit private sector entities, and the accounting provisions in the Guide do not apply to governmental plans. However, portions of those publications, including this Alert, may be useful to auditors of governmental plans. For example, auditors should consider referring to the Guide for specific auditing considerations relating to governmental plans (such as evaluating actuarial information). Although the audit objectives for governmental plans are similar to those for private-sector pension plans, the auditor should be aware that the Employee Retirement Income Security Act of 1974 (ERISA) does not apply to governmental entities. Instead, state and local laws

and regulations that govern the operations of governmental plans may affect, for example, allowable investments, investment income allocation, funding requirements, participant eligibility and vesting, and payments to plan members and beneficiaries.

Current Trends

Legislative Changes

Because of their overfunded status, many governmental plans have reduced or eliminated employer contributions for one or more years or enhanced participant benefits. You should be alert for contribution or benefit changes that may affect a plan's financial statements, note disclosures, and required supplementary information (RSI). GASB Statement No. 25, paragraph 35, requires governmental defined benefit pension plans to perform an actuarial valuation at least biennially, but also provides that a new valuation should be performed if significant changes have occurred since the previous valuation in benefit provisions, the size or composition of the population covered by the plan, or other factors that affect the results of the valuation.

Increasingly, governments are looking at defined contribution plans to provide benefits and expand choices for participants. You should be alert for such changes in the plans you audit because the adoption of defined contribution features could radically alter the nature of, the actuarial evaluation for, and the financial reporting and note disclosure for a defined benefit plan.

Investments

The financial performance of investment portfolios during the past two years generally has been below the expected long-term rate of return such that required levels of funding are beginning to increase. The rate of return assumption used in the actuarial calculations of funding and accumulated plan benefits should be continually reviewed for reasonableness. Any additional contribution amounts will have an impact on budgets of the plan sponsor.

Valuations for alternative and real estate investments may have declined due to general economic conditions or specific economic con-

ditions relating to an industry or a geographic location. You might need to review the valuation policies and the valuations for such investments. Governmental plans sometimes value those types of investments based on a three-month lag, and additional data could reveal a material change in value.

Plan investments are being held to a higher level of scrutiny because of the highly publicized bankruptcies of large publicly held companies and significant depreciation in fair value of investments in certain sectors. Boards of directors may increase their inquiry into the results and investment decisions for plan holdings. In addition, those losses, as well as recovery suits that some plans are pursuing against bankrupt companies, may affect the financial statements and note disclosure. GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, paragraph 75, requires disclosure of losses recognized during the period due to default by counterparties to investment transactions and amounts recovered from prior-period losses if not separately displayed on the operating statement. Although that disclosure, like all disclosures, applies only to material items, some users of financial statements may consider a multimillion dollar loss to be material, even in a multibillion dollar portfolio, given the highly publicized nature of some of these bankruptcies.

Internet Use

Governmental plans are increasing the use of the Internet for their memberships. Many plans now allow members to access their accounts and to initiate transactions over the Internet. The introduction of those capabilities will introduce new information technology (IT) applications and may introduce the use of service organizations to consider in your evaluation of the entity's *internal control over financial reporting*. They also raise the need for a plan to reevaluate its security and privacy policies and measures.

Help Desk—Think about refreshing yourself on the provisions of Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a*

Financial Statement Audit, which amended and expanded the discussion in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Business Continuity

The tragic events of September 11 reinforce the need for all organizations, including governmental plans, to have in place a good business continuity plan. A review of an entity's current continuity plan may uncover weaknesses in its internal control environment. A plan's continuity plan may be affected by the business continuity plans of service organizations, investment managers, and other business partners.

Governmental plans often outsource investment, accounting, and other functions to vendors. Some plans have had difficulties obtaining data about their transactions when they terminate a relationship with a vendor, resulting in financial reporting difficulties. You might want to alert a plan that it should consider reviewing its vendor contracts for appropriate provisions relating to ownership of and access to data underlying its transactions.

Additional Audit Issues

Investment Commitments

Alternative and real estate investments typically are not fully funded at inception and plans may carry significant unfunded commitments in these asset classes. The auditor should consider evaluating whether a plan has appropriately disclosed those commitments in conformity with GASB standards that require the disclosure of significant commitments.

Conflicts of Interest

You should consider reviewing investment transactions, particularly in the alternative and real estate investment asset classes, for possible conflicts of interest on the part of plan staff.

Boards of directors and their audit committees also are becoming more sensitive to independence issues and possible conflicts between the plan and vendors, including auditors. You should also

consider reviewing the plan's relationships with those organizations for possible conflicts.

GASB Statement No. 34

In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, which establishes a new financial reporting model for state and local governments. The requirements of the Statement are effective in three phases (starting for periods beginning after June 15, 2001) based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. Governmental plans often are component units of a primary government. GASB Statement No. 34 requires a component unit to implement its provisions no later than the same year as its primary government, even if that is earlier than its "assigned" phase based on the component unit's revenues in the first fiscal year ending after June 15, 1999. GASB Statement No. 34 encourages earlier application and some plans are adopting it early. A complete discussion of GASB Statement No. 34 and its related pronouncements, including GASB Statements No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and No. 38, *Certain Financial Statement Note Disclosures*, is in the AICPA Audit Risk Alert *State and Local Governmental Developments*.

Generally, GASB Statement No. 34 and its related pronouncements will have little effect on a governmental plan's financial statements. Nevertheless, you should review a plan's preparation for implementation, including its coordination of implementation timing with its primary government, if applicable. All plans will be required to add a management's discussion and analysis, and some plans may have some changes in note disclosures.

The AICPA plans to issue in 2002 a revision of its Audit and Accounting Guide for state and local governments for the effect of GASB Statement No. 34. That new Guide, like the current state and local government Guide, will apply to audits of governmental plans. A briefing on certain significant provisions of the new Guide, including the concept of "opinion units" for purposes of

planning, performing, evaluating the results of, and reporting on the audit, is in the AICPA Audit Risk Alert *State and Local Governmental Developments—2001*.

Help Desk—The GASB Web site at www.gasb.org summarizes the provisions of GASB pronouncements. Examples of governmental plan management discussion and analysis (MD&A) may be viewed at the following Web sites: California Public Employees Retirement System, www.calpers.ca.gov/; Delaware Public Employee’s Retirement System, www.delawarepensions.com/; Missouri State Employees Retirement System, www.mosers.org/; and the San Diego County Employees’ Retirement System, www.sdccera.org/.

Resources

See the “Resource Section” of the AICPA Audit Risk Alert, *State and Local Governmental Developments—2001* for a listing of resources for governmental plans.

INFORMATION SOURCES

<i>Organization</i>	<i>General Information</i>	<i>Fax Services</i>	<i>Web Site Address</i>
American Institute of Certified Public Accountants	<i>Order Department</i> Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 (888) 777-7077	<i>24 Hour Fax Hotline</i> (201) 938-3787	http://www.aicpa.org
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	<i>24 Hour Fax-on-Demand</i> (203) 847-0700, menu item 14	http://www.fasb.org
Department of Labor: Pension and Welfare Benefits Administration: Office of the Chief Accountant: Division of Accounting Services Division of Reporting Compliance Office of Regulations and Interpretations	(202) 693-8360 ERISA related accounting and auditing questions (202) 693-8360 Form 5500 preparation and filing requirements (202) 693-8360 (202) 693-8500		http://www.dol.gov/dol/pwba

