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A U D I T R I S K A L E R T S

Employee Benefit Plans Industry Developments — 2005

*Strengthening Audit Integrity
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

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Employee Benefit Plans Industry Developments — 2005

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Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

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 the SASs.

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

Linda C. Delahanty
Technical Manager
Accounting and Auditing Publications

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2004-2005 Employee Benefit Plans Audit Guide Revision Task Force

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Employee Benefit Plans Industry Developments—2005

How This Alert Helps You

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

Help Desk—See the AICPA Publication *Audit Risk Alert—2004/05* (product no. 022335) for general guidance. See the AICPA Audit Risk Alert *Independence and Ethics Alert—2004/05* (product no. 022475kk) for a thorough discussion of recent developments and key issues in the area of independence and ethics. It is important to point out that, for Employee Retirement Income Security Act of 1974 (ERISA) engagements, the Department of Labor (DOL) has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.88 in Appendix A of the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (EBP Guide), for a listing of the DOL's independence standards.

Industry and Economic Developments

Are you saving enough each month for your retirement? Individuals continue to underuse the options available to them to help them save for their own retirement. Many individuals still do not participate in their 401(k) programs, and of those who do, many do not contribute enough to receive the full company match. As traditional pension plans continue to decline, and with the

uncertain outlook for Social Security, the need for individuals to plan for their own retirement is critical. This section discusses the industry and economic environment, and other issues facing employee benefit plans today.

The AICPA Employee Benefit Plan Audit Quality Center

Financial statement audits of employee benefit plans represent a substantial portion of the many audits performed by CPAs each year. The AICPA is committed to helping its members achieve the highest standards in performing quality employee benefit plan audits.

On March 10, 2004, the AICPA launched the Employee Benefit Plan Audit Quality Center to help CPAs meet the challenges of performing quality audits in this unique and challenging area. The Center is a firm-based, voluntary membership center for firms that audit employee benefit plans. It helps those accounting firms demonstrate their commitment to employee benefit plan audit quality and assists them in applying a set of best practices. The Center currently has almost 900 members from around the country.

The Center's primary purpose is to promote the quality of employee benefit plan audits. To meet this goal, the Center:

- Has created a community of firms that demonstrate a commitment to employee benefit plan audit quality
- Serves as a comprehensive resource provider for member firms
- Provides information about the Center's activities to other employee benefit plan stakeholders
- Raises awareness about the importance of employee benefit plan audits

The Center offers resources to enhance the quality of audits of employee benefit plans by providing:

- A single point of access to the latest developments in accounting, auditing, and DOL rules and regulations
- Periodic updates on current issues through electronic news alerts, conferences, and Web casts

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- An online member discussion forum that provides the opportunity for member interaction and sharing of information and best practices
 - The voice for Center members to the DOL

The Center provides a Web site, www.aicpa.org/ebpaqc, dedicated to the latest developments in employee benefit plan audits. The Center also provides information to help educate plan sponsors, trustees, and other stakeholders about the importance of quality audits, how to select a plan auditor, how to contact the DOL, and other important issues that affect audit quality.

Center Membership Requirements

Member firms demonstrate their commitment to audit quality by joining the Center and agreeing to adhere to the membership requirements. To be eligible to be a member of the Center, the firm must:

- Designate an audit partner¹ to have firm-wide responsibility for the quality of the firm's ERISA employee benefit plan audit practice. (*Effective at admission date.*)
- Have all audit partners of the firm residing in the United States and eligible for AICPA membership be members of the AICPA.² (*Effective at admission date.*)
- Establish a program to ensure that all ERISA employee benefit plan audit engagement personnel possess current knowledge, appropriate to their level of involvement in the engagement, of applicable professional standards, rules, and regulations for ERISA employee benefit plan audits. Such knowledge may be obtained from on-the-job train-

1. An *audit partner* refers to an individual who is legally a partner, owner, or shareholder in a CPA firm or a sole practitioner and who performs audit services, concurring reviews (if applicable), or consultations on technical or industry-specific issues with respect to audit clients of the firm. Such an individual should be party to any partnership, ownership, or shareholder agreement of a CPA firm.

2. Member firms must use best efforts to ensure compliance with this membership requirement. Best efforts include (a) annually advising each audit partner that AICPA membership is mandatory and (b) taking appropriate corrective action in the event that the firm detects noncompliance. In addition, while only audit partners residing in the United States and eligible for AICPA membership must be members of the AICPA, member firms must encourage all other firm professionals who are eligible for membership in the AICPA to enroll as an individual AICPA member.

ing, training courses, or both. For an individual signing audit opinions and an individual managing ERISA employee benefit plan audit engagements, the individual must complete a minimum of eight hours of employee benefit plan-specific continuing professional education (CPE) within the three-year period (or within the firm's or individual's most recent CPE period ending within the three-year period) before signing an ERISA employee benefit plan audit opinion or managing³ an ERISA employee benefit plan audit engagement. Thereafter, the individual must have a minimum of eight hours of employee benefit plan-specific CPE every three years (or within the firm's or individual's CPE period covering a three-year period) where an individual continues in this capacity for ERISA employee benefit plan audits. *(Program must be in place at admission; CPE requirement must be met in the firm's or individual's first CPE cycle ending after January 1, 2005.)*

- Establish policies and procedures specific to the firm's ERISA employee benefit plan audit practice to comply with the applicable professional standards and Center membership requirements. These policies and procedures must be documented and appropriately communicated. *(Effective on or before December 31, 2004.)*
- In addition to meeting the quality control standards requirement for monitoring, establish annual internal inspection procedures that include a review of the firm's ERISA employee benefit plan audit practice by individuals possessing current experience and knowledge of the accounting and auditing practices specific to ERISA employee benefit plan audits. The engagements inspected should be representative of the firm's ERISA employee benefit plan practice, considering the number and different types of plan audits (for example, defined benefit, defined contribution, health and welfare, multiemployer, employee stock option plans

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3. Individuals managing the audit engagement are professional employees who have either continuing responsibility for the overall planning and supervision of the engagement or the authority to determine that an engagement is complete subject to final partner approval if required.

(ESOPs), limited, and full scope) and the various locations at which those audits are performed. The internal inspection should include reviewing the firm's compliance with the Center membership requirements. The internal inspection reports specific to the ERISA engagements should be made available to the firm's peer reviewer. *(Effective for firm monitoring performed beginning after January 1, 2005.)*

- Make publicly available information about its most recently accepted peer review as determined by the Executive Committee.⁴ *(Effective at admission date.)*
- Have its ERISA employee benefit plan audits selected as part of the firm's peer review reviewed by individuals employed by a Center member firm. *(Effective for peer reviews commencing on or after January 1, 2005.)*
- Periodically file with the Center information about the firm and its ERISA employee benefit plan audit practice, and agree to make such information available for public inspection, as determined by the Executive Committee.⁵
- Pay dues as established by the Executive Committee.

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4. The Executive Committee has determined that Center member firms are required to make publicly available the following information, if applicable, relative to the firm's peer review:

- Peer review report letter of comment, if applicable
- Letter of response, if applicable
- Letter signed by the reviewed firm indicating that the peer review documents have been accepted with the understanding that the firm agrees to take certain actions, if applicable
- Letter notifying the firm that certain required actions have been completed, if applicable
- Letter notifying the firm that the peer review has been accepted

5. The Executive Committee has determined that Center member firms are required to file with the Center the following information:

- Firm name and address
- Indicate whether the firm is a member of the CPCAF and/or PCPS
- Name and contact information of the designated audit partner with firm-wide responsibility for the quality of the firm's ERISA employee benefit plan audit practice
- Name and contact information of the firm's designated Center contact administrator (if different from designated person above)
- Total number of CPAs in owner's group, CPAs in firm, professional staff, and firm personnel
- Approximate number of ERISA employee benefit plan audits (i.e., 1-5, 6-25, 26-50, 51-100, 101-500, over 500)

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- Comply with additional requirements as may be established by the Executive Committee and approved by the AICPA Board of Directors.

Help Desk—Visit the Employee Benefit Plan Audit Quality Center Web site at www.aicpa.org/ebpaqc for more information about the center's activities and how to join.

Effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on Plans

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

For both single-employer and multiemployer health and welfare benefit plans, the question has arisen whether the effects of the plan sponsor's (employer's) Medicare subsidy should be taken into consideration when calculating the health and welfare plan's

postretirement benefit obligation. The planning subcommittee to the AICPA Accounting Standards Executive Committee is considering this issue. Be alert for further developments on this topic at the AICPA Web site at www.aicpa.org.

Economic Environment

In planning their audits, auditors need to understand the economic conditions facing their client's industry. Economic activities relating to such factors as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on the entity being audited.

Over the last year, the combined stimulants of easy fiscal and monetary policies contributed to a powerful economic rebound. While the economy experienced good growth in the third and fourth quarters of 2003, gross domestic product (GDP), which is the broadest measure of economic activity, is still growing at a healthy annual rate. In fact, GDP rose 4.4 percent in 2004, its best performance in five years. Moreover, the U.S. financial system is strong and well-positioned, and the stock markets have been enjoying positive growth and gains. U.S. businesses continue to deliver strong results, leveraging the cost cutting and restructuring of the past several years.

Importantly, the current rise in payrolls removes concerns of a jobless recovery. The unemployment rate has turned sharply lower from the peak of 6.4 percent in June 2003. The unemployment rate averaged 5.5 percent in 2004. In 2004, approximately 2.2 million jobs were added.

The Federal Reserve has been raising interest rates recently, up from a 46-year low of 1 percent, while stating it intends to raise rates in a measured fashion during what it believes is a self-sustainable economic recovery.

Consumers had more money in their pockets due to the \$330 billion in tax cut package passed in May 2003 and low interest rates, which gave rise to a strong housing market that let homeowners tap into home equity lines of credit and refinance mortgages.

Economists are predicting steady growth for the U.S. economy, at a rate expected to be more than twice that of Europe's. Headwinds for the U.S. economy consist of geopolitical concerns, terrorism, high energy prices, inflation, and rising interest rates.

Health and Welfare Benefit Plans—Health Savings Accounts and Health Reimbursement Arrangements

Health Savings Accounts

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 created the Health Savings Account (HSA), effective January 1, 2004, which replaces the Archer Medical Savings Accounts (MSAs), which expired on December 31, 2003. Individuals enrolled in certain high-deductible health plans (HDHPs) can establish HSAs to receive tax-favored contributions (from either the employee or employer). The contribution made to the HSA is distributed on a tax-free basis to pay or reimburse qualifying⁶ health expenses, may be used for future expenses, or may be used (on a taxable basis) for non-health purposes. Funds held in the HSA can be used to pay premiums for long-term care insurance, and can be used to pay for health insurance premiums while receiving unemployment benefits or continuation benefits under the Consolidated Omnibus Budget Reconciliation Act. The HSA's funds are required to be held by an insurance company or trustee (bank).

An HDHP must have a deductible of at least \$1,000 for self-only coverage and \$2,000 for family coverage, with annual out-of-pocket expenses limited to \$5,000 for self-only coverage and \$10,000 for family coverage. Beginning in 2005, these limits will be adjusted for inflation. In addition, there are maximum annual contributions (adjusted annually for inflation) that can be made to an HSA depending on factors such as age and coverage election (such as self-only or family).

HSAs generally will not constitute "employee welfare benefit plans" for purposes of the provisions of Title I of ERISA.⁷ How-

6. This refers to qualified health expenses as defined under Section 213(d) of the Internal Revenue Code.

7. See U.S. Department of Labor Field Assistance Bulletin 2004-1.

ever, unless exempt under Title I (for example, governmental and church plans), an employer-sponsored HDHP that underlies a HSA would be within the meaning of ERISA section 3(1) and subject to Title I.

HSAs' popularity is expected to increase, given that they can be funded on a tax-favored basis, they can pay most medical expenses on a tax-free basis, unused amounts can be rolled forward to future years (or can be withdrawn at age 65 as supplemental retirement income), and they are portable.

Health Reimbursement Arrangements

A Health Reimbursement Arrangement (HRA) is similar to an HSA; however, HRAs are funded solely through employer contributions and may not be funded by the employee through a voluntary salary reduction agreement. There is no requirement for the arrangement to be part of an HDHP, and the funds can be held by the employer or a voluntary employees' beneficiary association (VEBA) trust. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period. Amounts remaining at the end of the year can generally be carried over to the next year. The employer is not permitted to refund any part of the balance to the employee, the account cannot be used for anything other than reimbursements for qualified medical expenses, and remaining amounts are not portable upon termination once the employee leaves the employer. HRAs are employer-established benefit plans and may be offered with other health plans, including flexible spending accounts (FSAs).

Audit Requirements

When HSAs or HRAs are standalone, they have no audit requirement. However, HSAs and HRAs that are a component of a health and welfare plan are subject to audit, as are the other components of that health and welfare plan.

Mutual Fund Industry Abuses and Related Guidance Issued by the Department of Labor

In April 2004, the Securities and Exchange Commission (SEC) issued final rules to prevent late trading and to curb market timing

abuses. The rules to prevent market timing abuses include, among others, rules that require explicit disclosure in fund-offering documents of market timing policies and procedures. The final rules are available on the SEC Web site at www.sec.gov.

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

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

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

funds, or opt for other investments or investment options for participants.

According to the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (EBP Guide) (paragraph 7.15), one of the objectives of auditing procedures applied to benefit plan investments is to provide the auditor with a reasonable basis for concluding whether investment transactions are initiated in accordance with the established investment policies of the plan. As part of a full-scope audit, auditors should review relevant plan documents, such as the latest plan agreement, investment adviser agreements, and investment policy statement. Auditing procedures for investments (EBP Guide, paragraph 7.16) also include inquiring of the plan administrator or other appropriate parties if they are aware of any situation where the plan's investments or other transactions violate applicable laws or regulations. The auditor should consider whether management has identified any noncompliance with the stated investment restrictions and test the compliance with the restrictions to the extent considered necessary. A benefit plan sponsor's failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the plan.

The auditor of an employee benefit plan should be aware of the possibility that violations of laws and regulations may have occurred. If specific information that provides evidence concerning the existence of possible violations affecting the financial statements comes to the auditor's attention, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred [see Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.07)].

Labor Department Issues Guidance on Fiduciary Duties in Response to Mutual Fund Abuses

On February 17, 2004, the Employee Benefit Security Administration (EBSA) announced guidance on the duties of employee benefit plan fiduciaries in light of alleged abuses involving mutual

funds. There are approximately 730,000 private sector pension plans, covering 102 million individuals, protected by the fiduciary responsibility provisions of ERISA. These plans hold more than \$1.1 trillion of assets invested in mutual funds and similar pooled investment vehicles, representing more than 30 percent of all pension plan investments.

The guidance addresses the obligations of fiduciaries to review their mutual fund and pooled investment fund investments with respect to reported and potential late trading and market-timing abuses. The guidance also provides examples of steps that fiduciaries can take to deal with market-timing concerns within their own plans without losing the protection of ERISA section 404(c). This guidance comes as federal and state investigations of late trading and market-timing abuses involving mutual funds have raised a number of questions about what steps fiduciaries should take with respect to their plans' mutual fund investments and other, similar types of investments.

In addition, the EBSA is conducting reviews of mutual funds, similar pooled investment funds, and service providers for such funds to determine whether there have been any violations of ERISA. As with EBSA's investigations involving corporate fraud and similar misconduct, these investigations are being coordinated with other federal agencies through President Bush's Corporate Fraud Task Force.

The guidance is available on EBSA's Web site at www.dol.gov/ebsa, under Compliance Assistance.

The Use of SAS No. 70 Reports When Auditing Employee Benefit Plans

Employee benefit plan sponsors typically use third-party service providers in some capacity to assist in administering their plans, and as a way to reduce costs and increase efficiencies. 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.⁸ SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, provides, among other things, guidance on the factors an independent auditor should consider when auditing the financial statements of a plan that uses a service organization to process certain transactions. For guidance on using a SAS No. 70 report when auditing employee benefit plans or for when no SAS No. 70 report is available, see Chapter 6 of the EBP Guide. For further guidance on subservice organizations, see paragraph 6.17 of the EBP Guide and Chapter 5 in the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk).

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

Complementary User Organization Controls

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

Fiduciary Oversight

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

- Review of third-party service provider's SAS No. 70 report
- Fluctuation analysis or reasonableness review of periodic third-party service provider reports with reconciliations with and comparisons to client data

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

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- 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

SAS No. 70 Report Exceptions and Qualifications

It is not uncommon for a type 2 SAS No. 70 report to have exceptions in tests of operating effectiveness. Those exceptions may result in a qualification of the report. Auditors should consider the following when a SAS No. 70 report contains exceptions to determine if an expansion of the scope of detailed testing is required:

- Whether the exception is related to user organization activities.
- The nature of the exception based on details provided in the SAS No. 70 report and inquiries of the user organization personnel and/or the service auditor.
- Whether any follow-up procedures and additional testing have been performed by the user organization or service organization to address the exception.
- Whether compensating controls exist that would mitigate the effect of the exception.

Auditors should consider whether they are able to rely on controls at the service organization if there are exceptions noted in the SAS No. 70 report.

A SAS No. 70 report may be qualified for the following reasons:

- The service organization’s controls are not correctly described.
- Controls were not suitably designed to achieve the specified control objectives.

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- The controls that were tested were not operating effectively (exceptions in testing).

Auditors should consider the following when a SAS No. 70 report is qualified to determine if an expansion of the scope of detailed testing is required:

- Whether the qualification is related to user organization activities.
- The nature of the qualification based on details provided in the SAS No. 70 report and inquiries of the user organization personnel, the service auditor, or both.
- Whether any follow-up procedures and additional testing have been performed by the user organization or the service organization to address the reason for the qualification.
- Whether compensating controls exist that would mitigate the effect of the qualification.

Auditors should determine whether they can rely on a qualified SAS No. 70 report.

What If the Service Organization Has Internal Control Reports Other Than a SAS No. 70 Report?

Service organizations may receive various reports on internal control. The objectives and work products of these other engagements differ from the objectives and work product of a service auditor's engagement because they do not provide a user auditor with the information as well as the assurance provided by a service auditor's report. The independent auditor may only rely on internal control reports issued by service organizations under SAS No. 70 and accompanied by an opinion from an independent public accounting firm. A type 1 SAS No. 70 report may be relied upon in connection with gaining an understanding of the plan's control environment. Only a type 2 SAS No. 70 report may be relied upon to reduce the scope of substantive testing by the independent accountant. Other internal control reports provided by service organizations may not be relied upon by the independent auditor. Such other reports may include:

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- SysTrustSM reports⁹
 - Transfer agent internal control reports filed with the SEC under the Securities Exchange Act of 1934 (1934 Act) rule 17Ad-13¹⁰
 - Broker-dealer internal control reports filed with the SEC under the 1934 Act rule 17a-5¹¹
 - SAS No. 70 reports accompanied by an opinion from an entity that is not a licensed public accounting firm

Help Desk—It has come to the AICPA’s attention that in some cases, service auditors’ engagements are being performed and reported on by consulting organizations that are not licensed CPA firms. SAS No. 70, which is part of generally accepted auditing standards, is intended for use by licensed CPAs. For a user auditor to use a service auditor’s report, it must be issued by a licensed CPA. CPAs may not use a report provided by an unlicensed individual or entity. User auditors should be alert to the possibility that a service auditor’s report may not have been prepared by a licensed CPA and should consider contacting a representative of an unfamiliar organization to verify that the organization is properly licensed, peer reviewed, and able to provide its peer review report and letter of comments and response. If the organization is unlicensed, CPAs are advised to convey that finding to the state board of accountancy in the state in which the engagement was performed or to their own state board.

Independence Issues

Recent news reports state that companies are changing auditors at record rates. This holds true for auditors of plans as well. Given the current environment, it is important to recognize that there are independence issues that should be addressed. Be alert that for ERISA engagements, the DOL has separate independence

9. See paragraph 1.20 in the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, to understand the differences between a SysTrust report and a SAS No. 70 report.

10. This typically a restricted-use report and is not intended to be and should not be used by anyone other than the specified parties.

11. Same as footnote 10.

standards that may be more restrictive than those of the AICPA or SEC. See paragraph A.88 in Appendix A of the EBP Guide for a listing of the DOL's independence standards.

Regulatory Developments

EBSA-Enhanced Programs to Assess Plan Audit Quality

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

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

Audit quality will also be the primary focus of much of the EBSA's desk reviews. The agency will focus its in-house work on reviewing copies of selected audit working papers prepared by firms with small to medium-size audit practices. In instances in which deficient audit work is identified, the related Form 5500 filings will be subject to rejection, and auditors will potentially face referral to the AICPA's Professional Ethics Division or State Board of Public Accountancy.

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

The EBSA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans.

Participant contributions are plan assets on the earliest date that they can reasonably be segregated from the employer's general assets, but in no event later than (1) for pension plans, the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer, and (2) for welfare plans, 90 days from the date on which such amounts are withheld or received by the employer.

Reporting of Late Remittances

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

Information on all delinquent participant contributions should be reported on line 4a of either Schedule H or Schedule I of Form 5500, regardless of the manner in which they have been corrected. In addition, plan administrators should correct the prohibited transaction with the IRS by filing a Form 5330 and paying any applicable excise taxes.

Beginning with the 2003 Form 5500, information on delinquent participant contributions is no longer required to also be reported on line 4d of Schedule H or Schedule G. For large plans that are subject to the audit requirement:

- Delinquent participant contributions reported on line 4a that constitute prohibited transactions (excluding those that have been corrected under the Voluntary Fiduciary Correction Program (VFCP) and for which the conditions of Prohibited Transaction Exemption (PTE) 2002-51 have been satisfied, as described below) may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the independent qualified public accountant (IQPA).
- ERISA and DOL regulations require additional information to be disclosed in supplemental schedules. Some of this

information is required to be covered by the auditor's report. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), as amended, provides guidance on the form and content of reporting when the auditor submits a document containing information accompanying the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See Chapter 11, "Party in Interest Transactions," of the EBP Guide for further discussion of prohibited transactions.

Plan officials faced with remitting delinquent participant contributions should consider applying for the DOL's VFCP. Plans that fully comply with the program, including satisfaction of the conditions of PTE 2002-51, would:

- Receive a No-Action Letter issued by the DOL that provides for no imposition of section 502(l) penalties
- Receive relief from the excise tax provisions of the Internal Revenue Code
- Continue to report the occurrence and amount of the corrected delinquent remittances on line 4a of either Schedule H or Schedule I (but not on line 4d of Schedule H or Schedule G)
- Not be required to report such transactions as supplemental information if the plan is required to be audited since the transactions are not considered to be prohibited transactions

The EBSA's Web site, www.dol.gov/ebsa, contains useful information about the VFCP, including a fact sheet, a frequently asked questions section, and a sample No-Action Letter.

Reporting of Delinquent Loan Repayments

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

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

Accordingly, the Department will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan repayments is included on Line 4a of the Schedule H or Schedule I. Filers that choose to include such participant loan repayments on Line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

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

Help Desk—For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or the EBSA's Web site at www.dol.gov/ebsa. Also see the frequently asked questions about reporting delinquent participant contributions on the Form 5500 at the EBSA Web site at www.dol.gov/ebsa/faqs/faq_compliance_5500.html.

2004 Form 5500 Series

The DOL, IRS, and the Pension Benefit Guaranty Corporation (PBGC) have released the 2004 Form 5500 return/reports, schedules, and instructions to be used by employee benefit plans for plan year 2004 filings. The IRS has also released the Form 5500-EZ return and instructions to be used by certain one-participant retirement plans for plan year 2004 filings.

The Form 5500 and Form 5500-EZ for plan year 2004 are essentially unchanged from 2003. Certain modifications have been made to reflect changes in the law or regulations, to improve forms processing, and to clarify the instructions. The modifications to the Form 5500 Annual Report (the Form) for 2004 include the following:

Form 5500:

1. The instructions to the Form and schedules have been amended to advise that the Form and public schedules and attachments are subject to future publication on the Internet and to emphasize that inclusion of a Social Security number (SSN) anywhere on the Form or schedules except as required on Schedule SSA could result in the filing being rejected.
2. The instructions to line 4 now include a caution to emphasize that the failure to indicate that a plan was previously identified by a different employer identification number (EIN) or plan number (PN) could result in correspondence from the DOL or the IRS.
3. The instructions for lines 8a and 8b plan characteristic codes have been modified on page 19 to include new Code 3J for a United States-based plan covering residents of Puerto Rico and qualifying under both Code section 401 and section 8565 of the Puerto Rico Code.

Schedule B:

1. In line E, the order of choices for the type of plan has been changed to match the order of choices in Box A of the

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- Form 5500. The choices for line E are now (1) Multiemployer, (2) Single-employer, and (3) Multiple-employer.
2. Line 8c requirements for reporting average cash balance account data have been clarified.
 3. Changes made by the Pension Funding Equity Act of 2004 have been reflected in the instructions for lines 1d(2)(a), 1d(2)(c), 4a, 6a, 9c, 9f, 12a, and 12o.
 4. Lines 1d, 6a, and 9l have been modified to delete references to “OBRA ‘87” Current Liability and “OBRA ‘87” Full Funding Limitation because this limitation is not applicable for plan years beginning after December 31, 2003, under section 412(c)(7)(A)(i)(I) of the Code.

Other Schedules:

- Schedule D—The instructions for the Form 5500 and for Schedule D have been improved to make clear that plans and Direct Filing Entities (DFEs) filing Schedule D must use multiple standard form pages if necessary. Nonstandard attachments to the Schedule D may be rejected.
- Schedule I—The instructions to line 2c are improved to clarify the calculation of “other income.”
- Schedule SSA—The instructions on page 57 are modified to clarify reporting requirements and improve processing.

The official government printed forms are available by calling (800) TAX-FORM [(800) 829-3676]. Information copies of the forms, schedules, and instructions are available on the EBSA’s Web site at www.efast.dol.gov. Filers should monitor the EFAST Web site for information on approved software vendors when completing 2004 Forms 5500 by computer and for electronic filing options. Filers may contact the EFAST Help Line for general assistance by calling (866) 463-3278.

Correspondence From EFAST or the DOL Office of the Chief Accountant

Plan administrators often receive correspondence from the DOL regarding the Form 5500 filed for their pension and welfare ben-

efit plans. These letters are generated by both the EFAST processing center in Lawrence, Kansas, and the DOL's Office of the Chief Accountant (OCA) in Washington, D.C. Auditors are often asked by their clients to assist in the resolution of issues contained in these government letters.

EFAST-Generated Correspondence

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

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

Correspondence From the Office of the Chief Accountant

The DOL's OCA has the responsibility for enforcing ERISA reporting and disclosure requirements. This includes ensuring that the Form 5500 filings are filed timely and correctly, and determining whether plan audits are performed in accordance with professional auditing and regulatory standards. The OCA routinely queries the ERISA database and targets for review Form 5500 filings that satisfy certain criteria, including those filings in

which processing errors went uncorrected and those with improperly prepared auditor's reports. The OCA staff review the Form 5500 filings and also request copies of working papers that support audit engagements. If the OCA staff identifies problems, a formal enforcement process commences with the issuance of a Notice of Rejection (NOR) against the plan administrator.

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

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

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

Important Reminders

Plan administrators should make all efforts to respond timely and thoroughly to all correspondence they receive from the EFAST

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

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

2004 Form M-1 for Multiple Employer Welfare Arrangements

On December 11, 2004, the DOL published in the *Federal Register* the 2004 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). MEWAs are arrangements that offer medical benefits to the employees of two or more employers or to their beneficiaries. The 2004 form has few changes from the previous year.

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

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

Department of Labor's EXPRO Program

The ERISA allows the DOL to grant exemptions from all or any part of the restrictions imposed by ERISA's prohibited transaction provisions. PTE 96-62, known as EXPRO, provides an expedited process for parties to seek authorization from the DOL to engage in certain prohibited transactions. The exemption applies to certain prospective transactions between employee benefit plans and parties in interest where such transactions are specifically authorized by the DOL and are subject to terms, conditions, and representations that are substantially similar to exemptions previously granted by the DOL. The exemption affects plans, participants, and beneficiaries of such plans and certain persons engaging in such transactions.

PTE 96-62 requires that applicants demonstrate to the DOL that their proposed transactions are substantially similar to transactions in at least two exemptions previously granted by the department within five years of their submission. PTE 96-62 was amended in July 2002 to provide applicants with more cases on which to base their transactions. The amendment to EXPRO also provided applicants with an alternate method of satisfying the program's requirements; instead of having to cite as substantially similar two individual exemptions granted by the DOL within the previous five years, applicants may cite one individual exemption granted within the past 10 years and a transaction "authorized" under the EXPRO exemption within the past five years.

More than 300 EXPRO transactions have been authorized. EXPRO has significantly reduced the number of individual exemptions relating to routine transactions, thus allowing applicants to receive exemptions in a more timely fashion and often saving them the cost of going through the more formal process to obtain an exemption.

For more information about EXPRO and the transactions authorized under the program, visit EBSA's Web site at www.dol.gov/ebsa.

DOL Guidance on Missing Participants

The DOL has issued a Field Assistance Bulletin (FAB) providing guidance on the responsibilities of employee benefit plan fiduciaries in connection with missing participants in terminated defined contribution plans governed by ERISA.

FAB 2004-02 provides guidance on the steps plan fiduciaries should take to locate participants when defined contribution plans are terminated and how to distribute the assets of missing participants when fiduciaries' efforts to locate them are unsuccessful.

In most instances, according to the FAB, routine methods of delivering notice to participants, such as first-class mail or electronic notification, will be adequate. In the event, however, that such methods fail to obtain from the participant the information necessary for the distribution, or the plan fiduciary has reason to believe that a participant has failed to inform the plan of a change in address, plan fiduciaries need to take other steps to locate the participant or a beneficiary. These search methods include:

- Using certified mail.
- Checking records of related employer plans.
- Checking with the designated plan beneficiary for updated information concerning the location of the missing participant or asking the beneficiary to contact or forward a letter on behalf of the terminated plan to the participant.
- Using a letter-forwarding service. Both the IRS and Social Security Administration (SSA) offer such services, and plan fiduciaries must choose one service and use it in attempting to locate a missing participant or beneficiary.
- Using Internet search tools, commercial locator services, and credit reporting agencies.

In cases where participants cannot be located, or fail to elect a method of distribution, the FAB indicates that plan fiduciaries can follow the new safe harbor regulation governing automatic rollovers for guidance on distributing benefits.

The FAB is part of the department's ongoing compliance assistance program to help employers, plan officials, service providers, and others comply with ERISA. This and the other field assistance bulletins are available at the DOL Web site at: www.dol.gov/ebsa.

DOL Final Rule on Safe Harbor Rollovers

On September 27, 2004, the DOL issued a final rule regarding fiduciary responsibility under ERISA for safe harbor automatic rollover of plan distributions.

Certain distributions of retirement plan benefits must be automatically rolled over into an individual retirement plan when a separated worker fails to elect a distribution method. The final rule adopted by the department protects retirement plan fiduciaries from liability under ERISA by providing a safe harbor in connection with two aspects of the automatic rollover process: the selection of an institution to provide the individual retirement plan and the selection of investments for such plans.

To obtain relief under the safe harbor, a plan fiduciary must satisfy certain conditions. Among other things, the final rule provides that the selected plan provider must be qualified to offer individual retirement plans, investment products must be designed to preserve principal, and the fees and expenses for such plans may not exceed those charged by the selected plan provider to its other individual retirement plan customers.

The DOL also is adopting a class exemption from the prohibited transaction rules of ERISA that permits certain plan sponsors to use their own services and products in connection with rollovers from their own retirement plan.

The final rule and related class exemption were published in the September 28, 2004, *Federal Register*, and information relating to the releases may be obtained by visiting the DOL at its Web site, www.dol.gov/compliance.

Small Pension Plan Security Regulation

On October 19, 2000, the DOL published a final rule designed to safeguard small pension plan assets by adding new conditions

to the audit waiver requirement that focus on persons who hold plan assets, enhanced disclosure to participants and beneficiaries, and improved bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation. See Appendix F of this Audit Risk Alert for frequently asked questions on the small pension plan audit waiver regulation.

DOL Fiduciary Education Initiatives

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

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

- *Meeting Your Fiduciary Responsibilities*—To meet their responsibilities as plan sponsors, employers need to understand some basic rules, specifically, ERISA. ERISA sets standards of conduct for those who manage an employee benefit plan and its assets (called fiduciaries). This publication provides an overview of the basic fiduciary responsibilities applicable to retirement plans under the law.
- *Understanding Retirement Plan Fees and Expenses*—This booklet will help retirement plan sponsors better understand and evaluate their plan’s fees and expenses. While the focus is on fees and expenses involved with 401(k) plans, many of the principles discussed in the booklet also will have application to all types of retirement plans.
- *401(k) Plan Fee Disclosure Tool*—A form that provides employers with a handy way to make cost-effective decisions and compare the investment fees and administrative costs of competing providers of plan services is now available in MS Word format.

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- *Selecting an Auditor for Your Employee Benefit Plan*—Federal law requires employee benefit plans with 100 or more participants to have an audit as part of their obligation to file the Form 5500. This booklet will assist plan administrators in selecting an auditor and reviewing the audit work and report.
 - *Reporting and Disclosure Guide for Employee Benefit Plans*—This guide is intended to be used as a quick reference tool for certain basic reporting and disclosure requirements under ERISA.

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

DOL Proposed Rules Requiring Multiemployer Plan Model Notices

The DOL has proposed rules to implement provisions of the Pension Funding Equity Act of 2004, which require plan administrators of multiemployer pension plans to furnish annually a notice on the funding status of their plans. The agency believes that this proposed requirement represents a concrete step toward improving the financial integrity of the pension insurance system, including more disclosure of information on the funding of defined benefit plans. As a result, individuals and employers will have more ready access to information about the funding status of their plans as a way to ensure sufficient assets are available to pay future benefits.

The proposed regulation provides that a notice be sent annually to participants, beneficiaries, labor organizations, contributing employers, and the PBGC. The notice, which must be written in easily understood language, must include basic financial information about the plan, such as a statement about whether the plan is 100 percent funded. If the plan is less than 100 percent funded, the notice must include the plan's actual funded current liability percentage. The notice also must include a comparison of the plan's assets to benefit payments, a description of the law governing insolvent plans, and the PBGC's benefit guarantees. The pro-

posed rule contains a model notice to reduce compliance burdens on plans and their administrators.

Delinquent Filer Voluntary Compliance Program

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

Program Eligibility

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

Program Criteria

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

Penalty Structure

Per Day Penalty. The basic penalty under the program is \$10 per day for delinquent filings.

Per Filing Cap. The maximum penalty for a single late annual report is \$750 for a small plan (generally a plan with fewer than

100 participants at the beginning of the plan year) and \$2,000 for a large plan.

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

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

“Top Hat” Plans and Apprenticeship and Training Plans. The penalty amount for “top hat” plans and apprenticeship and training plans is \$750.

Internal Revenue Service and Pension Benefit Guaranty Corporation Participation

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

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

DOL Announces Proposed Amendments to Its Voluntary Fiduciary Correction Program

On April 5, 2005, the DOL announced a proposal to expand and simplify its Voluntary Fiduciary Correction Program (VFCP), which helps employers and their professional advisers voluntarily correct violations of the law for employee benefit plans. The new program is effective immediately and will be available during the comment period.

Proposed amendments to the VFCP include:

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

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

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

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

Help Desk—The EBSA provides a VFCP online calculator as a compliance assistance tool. This online calculator assists applicants in calculating VFCP correction amounts owed to benefit plans. For more information about the online calculator, visit the EBSA Web site at www.dol.gov/ebsa/calculator/main.html.

Field Assistance Bulletins

Field Assistance Bulletins (FABs) help the EBSA communicate technical guidance and important information about the agency's views on technical applications of ERISA. FABs are intended to educate and assist employers, plan officials, service providers, and others in achieving and maintaining compliance with ERISA. All FABs are posted on the EBSA's Web site and are available to the public at www.dol.gov/ebsa under Compliance Assistance. The following lists the FABs that have been issued since the last Audit Risk Alert:

- *Field Assistance Bulletin 2004-1*—Addresses whether health savings accounts established in connection with employment-based group health plans constitute “employee welfare benefit plans” for purposes of Title I of ERISA.
- *Field Assistance Bulletin 2004-2*—Addresses what a plan fiduciary needs to do to fulfill its fiduciary obligations under ERISA with respect to (1) locating a missing participant of a terminated defined contribution plan and (2) distributing an account balance when efforts to communicate with a missing participant fail to secure a distribution election.
- *Field Assistance Bulletin 2004-3*—Addresses the fiduciary responsibilities of a directed trustee in the context of publicly traded securities.

EBSA Outreach and Customer Service Efforts

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

In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to focus on plan audit quality, the current

Form 5500, the EFAST Processing System, and other agency-related developments. Questions regarding these outreach efforts should be directed to the Office of the Chief Accountant at (202) 693-8360. Practitioners and other members of the public may also wish to contact the EBSA at its Web site at www.dol.gov/dol/ebsa. The Web site also provides information on EBSA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Legislative Developments

Social Security is a critical component to the financial security for millions of retirees. Social Security provides more than half of the total income for almost 60 percent of beneficiaries, and more than 90 percent of income for almost 30 percent of beneficiaries. The current debate over the future of Social Security is one that should be followed closely, as pension reform may also be included in any proposed Social Security reform legislation.

Audit Issues

Common Audit Concerns

The following table lists specific areas, often overlooked, that auditors should pay particular attention to when auditing employee benefit plans and where in this Alert or the EBP Guide a discussion of the issue can be found:

<i>Hot Topic</i>	<i>Resource</i>
Eligible compensation and payroll data	Page 46
Auditing health and welfare plans	Page 36
The use of SAS No. 70 reports when auditing employee benefit plans	Page 12 and EBP Guide Chapter 6
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Auditing Health and Welfare Plans

Health and welfare plans continue to become more complex, more expensive, and more difficult to administer. This section is intended to describe certain areas unique to health and welfare benefit plans, including suggested audit procedures¹² such as:

- A. Understanding Health and Welfare Plans
- B. Rebates Receivable
- C. Contracts With Benefit Service Providers
- D. Accumulated Eligibility Credits
- E. Actuarial Data and Census Information
- F. Allocation of Expenses
- G. HIPAA Privacy Concerns
- H. About Health and Welfare Claims
- I. Stop-Loss Coverage
- J. Premium Stabilization Reserves
- K. COBRA

A. Understanding Health and Welfare Plans

Health care inflation, particularly in the area of prescription drugs, continues to grow with no apparent end in sight. The administration of health claims has always been complicated, and the requirements for more timely claims processing, appeal decisions, and the privacy requirements under HIPAA have added to these complexities. Due to the intricacies in the health care industry and the sheer magnitude of the dollars involved, trustees, administrators, and others involved are concerned with health and welfare fraud. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit.

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

When auditors are using standard audit programs for employee benefit plans, those programs should be tailored to the unique nature of health and welfare plans.

Before performing a health and welfare plan audit, it is critical for the auditor to establish a clear understanding of the plan. The audit requirement is of the plan, not the trust. Therefore, before conducting each audit, the auditor needs to understand the benefits offered by the plan. For those benefits offered, the auditor should consider the following:

- Which benefits are fully insured versus self-insured
- Who the providers are and the elements of the contractual arrangement with the plan
- For self-insured claims, how the various claims are administered and adjudicated, and how fees are charged
- What information systems are used to support the plan operations, and which of those are in-house systems or outsourced

When answering these questions, the auditor should consider the responses with regard to all covered participants (that is, active, COBRA, retirees, and so on). Understanding areas such as the various benefits offered, the providers, and the control environment are key to developing the audit approach and the sampling methodology.

B. Rebates Receivable

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

ceiving the rebate was the VEBA trust account, receipt of the rebate by the plan sponsor and deposit of such rebate into a non-trust account may not be appropriate.

C. Contracts With Benefit Service Providers

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

D. Accumulated Eligibility Credits

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

E. Actuarial Data and Census Information

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

F. Allocation of Expenses

In multiemployer plans or large employers, the health and welfare plan often shares office space, employees, and other expenses with the sponsoring organization or with other plans. The allocation of expenses shared by these organizations should be made on a logical and systematic basis. No plan should pay more than its fair share of expenses. The auditor should review the allocation to ensure that it is reasonable and current. An allocation methodology calculation that is over three years old could be outdated and may need to be revised.

G. HIPAA Privacy Concerns

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.

On February 20, 2003, the security rules under HIPAA were finalized. The rules are effective for most health plans on April 21, 2005 (small health plans, as defined, will have until April 21, 2006, to comply).

Business Associates Agreements. HIPAA requires that plan sponsors enter into a business associates agreement with any of their service providers that have access to any protected health information (PHI). If asked to sign such confidentiality, indemnification, or business associates agreements, auditors need to take special care in reviewing these agreements. Often the auditor may not agree with certain language in the agreement, resulting in delays in the audit until mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. 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, or a third-party administrator's refusal to provide access under any circumstances, a scope limitation could result.

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

- Restricting access to the working papers
- Providing an accounting of disclosures of PHI

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- Reporting to the sponsor any misuse of PHI by the accounting firm

Auditors should follow the documentation requirements of SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339),¹³ and their documentation should include:

- Summary of evidence obtained, reviewed, and tested.
- Identification of actual selection made for testing, such as claim number, dollar amount, and check number. Due care should be taken to employ an alternative system of participant identification to avoid identification of the participant in the working papers.
- Names of individuals at the sponsor or third-party administrator with whom discussions were held to determine propriety of payment or other operational procedures.
- Methodology employed to determine sample size and selection criteria.

H. About Health and Welfare Claims

The auditor should have a basic understanding of the terms of the plan and have the skill and knowledge to test that claims are being properly adjudicated. It is not expected that the auditor would have the knowledge of a skilled billing claims specialist or a skilled medical specialist when claims are processed by a third-party administrator. The auditor should be aware, however, of the typical problems that a health and welfare plan might experience when processing claims. These problems may include:

- Unbundling (charging for performance of multiple procedures when only one procedure was performed)
- Upcoding (charging for a higher level of service than the procedure actually performed)
- Fictitious services by service providers

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13. Form 11-K filers should follow Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, AU sec. 339). PCAOB Auditing Standard No. 3 supersedes SAS No. 96 for audits of issuers only.

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- Performance of unnecessary services
 - Duplicate claims
 - Duplicate coverage
 - Kickbacks
 - Nontransmittal of rebates and discounts
 - Abuse
 - Ineligibility

The auditor should be aware of any processing problems with claims that the plan is encountering and should discuss with the plan administrator and others what the plan is doing to confront these issues. See Appendix C of this Audit Risk Alert for claims testing information.

What types of errors does the auditor find in testing health and welfare claims? The errors typically found include:

1. *Eligibility.* Testing for eligibility is different from those procedures for a pension or 401(k) plan. In many cases the person receiving the benefit is different from the actual participant. Audit procedures should include verifying the coverage elected by the participant at the date of service. Many plans allow coverage for a spouse, dependents, or other family members. Most problems with eligibility relate to a participant who terminates and whose eligibility ceased before the date of service for which the claim was filed.
2. *Wrong individual.* The claim was paid for the wrong person. This occurs when two or more participants have the same or similar names. Claims are also paid for the wrong family member.
3. *Other errors* in the diagnosis code, the CPT/HCPCS code,¹⁴ or errors in the information in the claims form.

14. Physicians' Current Procedural Terminology (CPT) is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The Health Care Financing Administration (HCFA) developed level II and level III codes in its Healthcare Common Procedure Coding System (HCPCS codes) to bill for supplies and services not covered by a CPT code (level I).

I. Stop-Loss Coverage

One way for a plan to protect itself against excessive losses is to purchase stop-loss insurance. Stop-loss insurance can be either specific or aggregate. Specific stop-loss insurance protects the plan against claims that exceed a predetermined maximum per person or per family. All claims above the specific stop-loss amount (for example, \$25,000) are normally reimbursed at 100 percent up to a limit contained in the plan.

Aggregate stop loss reimburses the plan when total eligible claims exceed a predetermined aggregate, such as 125 percent of expected claims.

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

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

J. Premium Stabilization Reserves

In some fully insured or minimum premium arrangements, an insurance company may require a contract holder to maintain a premium stabilization reserve. Such reserves are usually adjusted by the insurance company at the end of the policy year. The annual adjustment is often the computed difference, or some factor thereof, between actual claims experience of the insurer and premiums paid by the contract holder. Generally, premium stabilization reserves are held in the general assets of the insurance company and are used to pay future premiums of the contract holder. If the premium stabilization reserve is certain to provide future benefits to the plan, the reserve is reported as an asset of the plan. In some cases, the contract holder may liquidate the

premium stabilization reserve via cash payment from the insurance company. In other cases, the premium stabilization reserve is forfeited by the contract holder in the event of termination of coverage. Criteria for realization of the reserve should be considered when evaluating the existence of the asset.

K. COBRA

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

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

Proposed Rules on Notices for COBRA Continuation Health Care Coverage. On May 25, 2004, the DOL announced final rules clar-

ifying the requirements for notices under COBRA for employees, employers, and plan administrators. The final rules provide guidance and model notices for workers and family members to continue their group health care coverage. Under COBRA, most group health plans must give employees and their families the opportunity to elect a temporary continuation of their group health coverage when coverage would otherwise be lost for reasons such as termination of employment, divorce, or death. COBRA requires that certain notices be given before individuals can elect COBRA coverage. The plan administrator must give employees and spouses a general notice explaining COBRA when the employees and spouses first become covered under the plan. When an event occurs that would trigger a right to elect COBRA coverage, either the employer or the employee and his or her family members must notify the plan of the event. Finally, when the plan receives this notice, the plan must notify individuals of their COBRA rights and allow them to elect continuation coverage.

To give plans time to modify their notice procedures, the new rules will be effective the first plan year that begins six months after publication of the rules in the *Federal Register*. Before that date, plans may rely on either the proposed rules or the final rules (including the model forms as proposed or as finalized) to meet their COBRA notice obligations. Model notices contained in the regulation are available for download from the EBSA's Web site at www.dol.gov/ebsa. The final regulations were published in the Federal Register on May 26, 2004.

Auditing Interpretation No. 17, “Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards”

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 internal control in an audit of a nonissuer's financial statements in accordance with generally accepted auditing standards (GAAS). That consideration is intended to provide the auditor a

sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. The scope of the auditor's procedures required under SAS No. 55 is considerably less than that required for an attestation of internal control pursuant to Section 404(b) of the Sarbanes-Oxley Act. To clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Act is applicable, the following language may be added to the auditor's standard report (full-scope audits only):

Independent Auditor's Report

[Same first paragraph as the standard report]

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[Same opinion paragraph as the standard report]

Eligible Compensation and Payroll Data

Eligible Compensation

Plan documents specify the various aspects of compensation (for example, base wages, overtime, and bonuses) that are considered in the calculation of plan contributions for defined contribution

plans and in the determination of benefits in a defined benefit plan. Testing of payroll data should address the determination of eligible compensation for individual employees and comparison of the definition of eligible compensation used in the calculation to the plan document. Since this process is generally not included in the payroll testing of the plan sponsor or in type 2 SAS No. 70 reports, a comparison of eligible compensation per the plan document to eligible compensation used in plan operations is required.

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

Payroll Data

Reliance is often placed on testing of payroll performed in conjunction with a corporate audit; however, these procedures, which generally include only high-level analytics with limited or no documentation of the control environment or performance of substantive procedures, are not sufficient to satisfy the payroll testing requirements. Often payroll processing is outsourced to an outside service provider that may have a SAS No. 70 type 1 report, which provides a description of procedures and controls, but does not have a SAS No. 70 type 2 report, which also includes testing of the procedures and controls and can be used to reduce the scope of substantive testing. Paragraph 10.05 of the EBP Guide describes procedures the auditor should consider to test payroll in conjunction with the plan audit. Also see Appendix D of this Audit Risk Alert for guidance on payroll auditing.

Consideration of Fraud in Employee Benefit Plan Engagements

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in

a financial statement audit. SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 99 was effective for audits of financial statements for periods beginning on or after December 15, 2002.

Practical Guidance

The AICPA Practice Aid *Fraud Detection in a GAAS Audit, Revised Edition* (product no. 006615kk) provides a wealth of information and can help in complying with the provisions of SAS No. 99. Moreover, this Practice Aid will assist auditors in understanding the requirements of SAS No. 99 and whether current audit practices effectively incorporate these requirements. This Practice Aid is an *Other Auditing Publication* as defined in 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.

The Practice Aid states that the changes in SAS No. 99 required more work in every audit in both identifying and responding to the risk of material misstatement due to fraud. Changes effected by SAS No. 99 include:

1. A required brainstorming session among the audit team members to discuss the potential for material misstatement due to fraud.
 - a. The meeting should include all audit team members (including the partner). It is important that experienced team members share information about their experiences with the client. Senior team members must set the proper “tone at the top” for conducting the audit, and convey the need to conduct the audit using a proper level of professional skepticism and to remind everyone on the team that the possibility of fraud does exist in every engagement.

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4. The consideration of other information, such as client acceptance and continuance procedures, during the information-gathering phase.
 5. Expanded guidance on evaluating information obtained and identifying the risks that may result in a material misstatement due to fraud. The auditor needs to perform an effective synthesis of the identified risks in an effort to:
 - a. Determine where the entity is most vulnerable to material misstatement due to fraud.
 - b. The types of frauds most likely to occur.
 - c. How those material misstatements are likely to be concealed.
 6. The presumption that improper revenue recognition is a fraud risk in all entities. For employee benefit plans, this risk is primarily related to investment income resulting from inappropriate investment valuation. For multiemployer plans, the auditor should consider whether employers are motivated to understate the employer contributions due.
 7. Mandate of certain audit responses on every audit engagement. These responses are designed to specifically address the risk of management override over internal controls. The risk of management override of controls should be considered a fraud risk in every audit and the auditor should perform tests in response to it [for example, journal entries, accounting estimates, unusual transactions (business rationale)].
 8. Requirements for the auditor to take into account an evaluation of the entity's programs and controls that address the identified fraud risks. Examples of programs and controls for employee benefit plans include those listed in Appendix B of the AICPA Audit and Accounting Guide *Employee Benefit Plans* (the EBP Guide). The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud.

The use of service providers to perform administrative functions does not eliminate the requirements of SAS No. 99. The plan sponsor still has user controls and responsibilities for data submitted to service providers. The auditor should consider:

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

The Auditors' Response

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

1. A response that has an overall effect on how the audit is conducted.
2. A response to identify risks involving the nature, timing, and extent of audit procedures.
3. A response to address management override of controls.

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

The Importance of Exercising Professional Skepticism

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

Underfunded Pension Plans and Cash Balance Plans

Many companies continue to have defined benefit plans in which the obligations owed to retirees exceed the assets in the plans. These companies are faced with making large contributions to those plans to meet legal requirements and make up the shortfall. The current shortfall in many of the nation's pension plans may become a major crisis. So many pension plans are failing that the PBGC, the agency that insures and bails out corporate pension plans, is facing growing deficits and an increasingly precarious financial position.

Impact on Plan Sponsor

The impact on a plan sponsor's financial statements has been an increase in pension expense and in many cases the need to record an additional minimum liability in accordance with FASB Statement No. 87, *Employers' Accounting for Pensions*. Accordingly, information about pension costs has received increased attention. In an effort to provide the public with better and more complete information about pensions, the FASB reissued Statement No. 132(R), *Employers' Disclosures about Pensions and other Postretirement Benefits—an Amendment of FASB Statements No. 87, 88, and 106* (revised 2003). Although FASB Statement No. 132(R) is not new, it has been amended to require companies to provide more details about their plan assets, benefit obligations, cash flows, benefit costs, and other relevant information. The additional disclosures are effective for fiscal years beginning after December 15, 2003, and quarters beginning after the same date.

As part of the Pension Funding Equity Act of 2004, the law provided that for two years (for example, for plan years beginning in 2004 and 2005), plan sponsors can use a long-term corporate bond rate instead of the rate on the 30-year Treasury bond. The long-term corporate rate is to be based on the top three levels of corporate bonds with average maturities of 20 years or more. This rate will be used for determining the current liability for plan funding and for determining the PBGC variable rate premiums. Plan sponsors can elect to disregard the interest rate change for the purposes of determining their maximum deductible contribution,

in which case they can use the 30-year Treasury bond rate. The change in interest rate does not apply to the calculation of lump sum payments.

Cash-Balance Plan Developments to Watch

Many companies have switched their defined benefit plans to cash-balance plans. Now federal court rulings have cast serious doubt on the future viability of cash-balance plans. The courts declared that the companies violated age discrimination laws and miscalculated payouts. These rulings are being appealed. If the appeals fail, cash-balance plans may become illegal and abandoned by companies.

Auditors should advise clients that have cash-balance pension plans or pension equity plans, or that are considering adopting either type of plan, to monitor this issue to determine what impact, if any, the court's decision or related actions (for example, congressional actions) could ultimately have on them. For clients that already have cash balance pension plans or pension equity plans, that determination should include an assessment of the matter in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, to ensure that appropriate financial statement disclosures are made based on the facts and circumstances. Given the nature of this issue, clients may want to seek the advice of competent legal counsel.

Accounting Guidance. Emerging Issues Task Force (EITF) Issue No. 03-4, *Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan*, contains some accounting guidance on these plans.

Current FASB Projects—Amendments of FASB Statements No. 87 and 35. Cash balance pension plans are not specifically addressed in FASB Statement No. 87, *Employers' Accounting for Pensions*. The FASB is currently undertaking a project to consider the appropriate pension obligation measurement model for all defined benefit plans that provide plan participants with a lump-sum benefit feature at the date of separation from employment. This project will not reconsider other fundamental aspects of pen-

sion accounting under Statements No. 87 and No. 35. The FASB staff plans to meet with the Board in the second quarter of 2005 to discuss the project's scope and the direction of the project. Visit the FASB Web site at www.fasb.org for further developments.

Allocation Testing for Defined Contribution Plans

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

Self-Directed Investments

Plan sponsors of participant-directed defined contribution plans continue to allow participants to expand their control over investment decisions, through self-directed investments,¹⁵ 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

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15. 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 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.

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. See paragraphs 7.61 through 7.63 of the EBP Guide for further guidance on self-directed features.

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

This Form 5500 reporting creates an issue with investment reporting in plan financial statements because generally accepted accounting principles (GAAP) requires certain reporting and disclosures. The following table summarizes the differences between the Form 5500 alternative reporting for participant-directed brokerage account investments and GAAP that may raise issues for auditors when obtaining brokerage window investment information.

<i>Form 5500—Alternative Reporting</i>	<i>GAAP—Required Reporting and Disclosures</i>
<ul style="list-style-type: none"> • Certain investments and related income (see previous paragraphs) made through participant-directed brokerage accounts may be shown as single line items on Schedule H. • Certain investments listed on the Schedule of Assets (Held at End of Year) may be shown as a single line item. 	<ul style="list-style-type: none"> • Identification of investments representing 5 percent or more of plan net assets in the plan's footnotes. (See paragraph 3.32h of the EBP Guide.) • Reporting of investment income, exclusive of changes in fair value, in the statement of changes in net assets or the footnotes. (See paragraph 3.29b of the EBP Guide.) • Reporting of net appreciation/depreciation by investment type in the plan's footnotes. (See paragraph 3.29a of the EBP 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, record-keepers, and service providers to maintain these records for audit and financial reporting purposes.

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

This alternative method of reporting participant-directed brokerage window investments does not relieve fiduciaries from their obligation to prudently select and monitor designated plan investment options and brokers.

Analytical Procedures as Substantive Tests

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

SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), as amended, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

Analytical Procedures in Planning the Audit

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

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

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

Analytical Procedures Used as Substantive Tests

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

The auditor considers the level of assurance, if any, he or she wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or as efficient as tests of details in providing the desired level of assurance.

The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among

other things, (1) the nature of the assertion, (2) the plausibility and predictability of the relationship, (3) the availability and reliability of the data used to develop the expectation, and (4) the precision of the expectation.

Documentation of Substantive Analytical Procedures

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

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

See SAS No. 56 for further guidance.

Examples of Analytical Procedures Used as Substantive Tests in Employee Benefit Plan Engagements

- *Investments.* Investment balances may fluctuate during the year based on changes in (1) investment strategy resulting from management decisions (or resulting from participant decisions, in the case of a defined contribution participant directed plan), (2) market trends, or (3) other plan changes (for example, merger or termination). Once the auditor understands what types of changes have occurred, an expectation can be developed.

Review market trends for similar types of investments and determine expectations based on plan activity (level of contributions or distributions) taking into account plan changes.

Oftentimes the recordkeeper or investment manager prepares quarterly investment return reports that can be used

to assist in developing an expectation. In addition, benchmarks for yields and total return can be obtained for asset classes or specific investments (for example, mutual funds).

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

Participant Contributions Example:

Prior-year headcount per the Form 5500 = 130 people

Prior-year participant contributions balance = \$401,828

Prior-year "average" participant
contribution = $\$401,828/130 = \$3,091$

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

$\$3,091 \times 50 \text{ people} = \$154,550$ expected contribution

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

- *Claims.* Determine number of claimants receiving claims in the prior year and the average claim per participant. Determine the number of claims during the year. Apply the average claim per participant to the expected number of claimants taking into account plan amendments, individual large claims, stop loss insurance coverage, or the health care cost trend rate increase.

Oftentimes the third-party administrator prepares quarterly reports which include headcount and claim information which can be used to assist in developing an expectation.

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

Limited-Scope Audits

ERISA section 103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency that acts as trustee or custodian. The election is available, however, only if the trustee or custodian certifies both the *accuracy* and *completeness* of the information submitted. Certifications that address only accuracy *or* completeness, but not both, do not comply with the DOL regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit. This *limited-scope* audit provision does not apply to information about investments held by a broker-dealer or an investment company. However, some broker-dealers and investment companies have established separate trust companies that will provide a limited-scope certification. The DOL has noted instances where limited-scope audits were performed when the financial institution did not qualify.

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

The limited-scope exemption applies only to the *investment* information certified by the qualified trustee or custodian, and does not extend to participant data, contributions, benefit payments,

or other information whether or not it is certified by the trustee or custodian. Thus, except for the investment-related functions performed by the trustee or custodian, an auditor conducting a limited-scope audit would need to include in the scope of the audit those functions performed by the plan sponsor or other third-party service organizations, such as third-party welfare plan claims administrators or third-party savings plan administrators, if circumstances necessitate. The nature and scope of testing will depend on a variety of factors, including the nature of the functions being performed by the third-party service organization; whether a SAS No. 70 report that addresses areas other than investments is available, if deemed necessary; and, if so, the type of report and the related results. (See Chapter 6 of the EBP Guide for a discussion of SAS No. 70.) The limited-scope audit exemption is implemented by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. The limited-scope exemption does not exempt the plan from the requirement to have an audit. Guidance on the auditor's report and responsibilities for this type of limited-scope audit is provided in paragraphs 7.64 and 13.26 through 13.31 in the EBP Guide. Exhibit 5-1 in the EBP Guide summarizes the conditions that generally allow for limited-scope audits in decision tree format.

See the "Investments" section of this Audit Risk Alert for guidance on limited-scope audit concerns related to investments.

Help Desk—Auditors should note that often the certification does not cover participant loans.

Initial Limited-Scope Audit in Current Year, Prior Year Limited-Scope Audit Performed by Other Auditors

An example of an initial limited-scope audit in the current year with the prior year limited-scope audit performed by other auditors for a profit sharing plan follows.

Report of Independent Certified Public Accountants

To the ABC Company Profit Sharing Plan and Participants:

We were engaged to audit the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing

Plan (the Plan) as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2. These financial statements and supplemental schedule are the responsibility of the Plan's management. The financial statements of the plan as of December 31, 20X1, were audited by other auditors. As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 (ERISA), the Plan Administrator instructed the other auditors not to perform, and they did not perform, any auditing procedures with respect to the information certified by the Trustee. Their report, dated May 20, 20X2, indicated that (a) because of the significance of the information that they did not audit, they were unable to, and did not, express an opinion on the financial statements taken as a whole and (b) the form and content of the information included in the financial statements other than that derived from the information certified by the Trustee, were presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the Plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in note E, which was certified by Bank & Trust Company, the trustee of the Plan, except for comparing such information with the related information included in the 20X2 financial statements and supplemental schedule. 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 trustee as of and for the year ended December 31, 20X2, that the information provided to the Plan administrator by the trustee is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements and supplemental schedule that we did not audit, we are unable to, and do not, express an opinion

on the accompanying 20X2 financial statements and supplemental schedule taken as a whole. The form and content of the information included in the 20X2 financial statements and supplemental schedule, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

Change in Trustee

An example of an auditor's report reflecting a change in trustee for a pension plan follows.

Report of Independent Certified Public Accountants

To the XYZ Pension Plan and Participants:

We were engaged to audit the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2, and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, and (2) Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did

not perform, any auditing procedures with respect to the investment information summarized in Note X, which was certified by the ABC Bank and XYZ Trust Company, the trustees of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that XYZ Trust Company held the Plan's investment assets and executed investment transactions from July 1, 20X2, to December 31, 20X2, and that ABC Bank held the Plan's investment assets and executed investment transactions as of December 31, 20X1, and for the period January 1, 20X1, to June 30, 20X2. The plan administrator has obtained certifications from the trustees as of and for the years ended December 31, 20X2 and 20X1, that the information provided to the plan administrator by the trustees is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the investment information certified by the trustees, have been audited by us in accordance with auditing standards generally accepted in the United States and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

Investments

Understanding Investments

Plan investments represent the majority of assets held by a benefit plan. Benefit plans invest in a wide variety of investments and

investment vehicles, some of which are not easily identified by review of the investment trust statements. It is important for auditors to gain an understanding of the types of investments the plan holds to determine the proper auditing procedures and accounting and reporting implications. This understanding can be obtained through (1) discussions with plan management, investment advisers, custodians or trustees, and (2) reviews of investment agreements, minutes of investment committee meetings, and other documentation. Chapter 7 of the EBP Guide provides a description of various investments and related audit procedures.

Pension funds, especially master trust arrangements and those with large investment portfolios, are more frequently investing in hard-to-value and alternative investments, including hedge funds, limited partnerships, real estate, and derivatives. In addition, many plans have added securities lending arrangements as a way to enhance investment performance. Special considerations should be given to auditing, accounting, and reporting procedures for such investments and investment arrangements.

This section discusses the following topics related to investments and helps you gain an understanding of typical investments found in employee benefit plans:

- A. Definitions of Investments
- B. Limited-Scope Considerations
- C. Securities Lending Transactions
- D. Limited Partnerships
- E. Omnibus Accounts
- F. 103-12 Entities
- G. What Are Derivatives? How Do I Audit Them?

A. Definitions of Investments

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

- *Master trust.* A trust for which a regulated financial institution (bank, trust company, or similar financial institution

that is regulated, supervised, and subject to periodic examination by a state or federal agency) serves as trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.

- *Common/collective trust.* A trust maintained by a bank, trust company, or similar institution, that is regulated, supervised, and subject to periodic examination by a state or federal agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of controlled group of corporations.
- *Pooled separate account.* An account maintained by an insurance carrier, which is regulated, supervised, and subject to periodic examination by a state agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of controlled group of corporations.
- *103-12 Entity.* An entity that is not a master trust, common/collective trust, or pooled separate account whose underlying assets include “plan assets” within the meaning of 29 CFR 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans.
- *Registered investment company.* An investment firm that is registered with the SEC and complies with certain stated legal requirements for the collective investment and reinvestment of assets contributed thereto from investors (employee benefit plans and nonemployee benefit plans).

B. Limited-Scope Considerations

In certain instances, a trustee/custodian may certify investments such as hard-to-value assets (such as limited partnerships, hedge funds, real estate, or derivatives) without having performed adequate year-end valuation procedures. For example, year-end values for limited partnerships are often certified by the trustee/custodian based on third-quarter statements provided by

the plan sponsor. If such investments have not had adequate year-end valuation procedures performed, the plan administrator should consider (1) requesting the trustee/custodian to exclude such investments from the limited-scope certification and (2) instructing the auditor to perform full scope procedures on such investments. Auditors should be aware that although they are not required to audit certain investment information when the limited-scope audit exception is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of preparing the financial statements.

Plan sponsors often use the information certified by the trustee/custodian to prepare the plan's financial statements. However, information certified by the trustee/custodian is not always in a proper financial statement format. Auditors should keep in mind that while they may not be auditing investments when performing a limited-scope audit, they are still responsible for ensuring that the required financial statement disclosures are adequate.

C. Securities Lending Transactions

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

For securities lending arrangements within a master trust, footnote disclosure of the master trust investments should include the collateral pledged as well as an offsetting liability for the return of the collateral. Since plan investments in a master trust are recorded as a single line item on the plan's statements of net assets, securities lending in the master trust would not be reflected in the face of the plan's financial statements. Often auditors are unaware that the plan has entered into these transactions because

the trustee/custodian nets the collateral assets against the collateral liabilities and the only indication is the existence of “other income” on the statements. Auditors should ask the plan sponsor and service providers about the existence of a securities lending arrangement as well as reviewing plan documents to determine the proper auditing procedures.

D. Limited Partnerships

Limited partnership private equity funds, including hedge funds, are pooled investment funds that are lightly regulated and not readily marketable, unlike registered investment funds, commonly known as mutual funds. Auditors should take special care in identifying when a plan invests in a limited partnership because it is not uncommon for such investments to be classified incorrectly (for example, as a registered investment company or other type of fund) on the schedule of investments provided by the custodian or trustee.

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 regarding a plan’s investments in limited partnerships.

The EBP Guide does not specifically address financial statement or Form 5500 reporting requirements for limited partnerships. Typically limited partnerships are reported on Schedule H Line a(5) or (15). Employee benefit plan financial statements report investments at fair value, which would include investments in limited partnerships.

Other required disclosures for limited partnership investments are those applicable under AICPA 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.

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 and the corresponding risk. A riskier, more aggressive investment would warrant consideration of additional disclosure.

- If a related-party relationship exists, the names of the other partners in the plan's partnership and their relationship to the plan.
- 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).
- Additional capital commitment requirements.
- Valuation methodology.

Paragraph 7.60 of the EBP Guide addresses auditing procedures for limited partnerships when performing full scope audits. Auditors should take special care in performing limited-scope audit procedures on limited partnership investments, as often the certifying entity does not have timely or accurate information regarding the amount and valuation of the plan's investment in the limited partnership. Although the auditor is not required to audit certain investment information when the limited-scope audit exemption is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of reporting on the financial statements (see paragraph 7.65 of the EBP Guide.) In addition, often the financial statements or appraisal prepared for limited partnerships do not have the same year end as the plan. The financial statements or appraisal need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. Auditors may wish to consider additional auditing procedures to address the gap in reporting, such as (1) requesting monthly financial activity of the partnership since the financial statement or valuation date and performing substantive analytics, (2) inquiring of the investment adviser about monthly

valuation procedures and any unusual investment activity changes that would result in significant changes in market value, and (3) evaluating the need for additional evidence to determine the fair value of the investments.

E. Omnibus Accounts

An omnibus account is an institutional account, often in the name of a custodian bank or an investment adviser, in which transactions are effected on behalf of a number of beneficial owners that are aggregated for trading purposes and are later allocated to those beneficial owners. Traditionally, although the bank or the investment adviser is expected to maintain records that reflect the transactions allocated among the beneficial owners or customers, any information regarding the identity of the customers for whom transactions were executed is frequently maintained by an affiliated recordkeeper. The recordkeeper system is the only record of an individual plan's activity within the investment fund. The following audit steps should be considered when auditing investments in omnibus accounts:

1. Confirm overall values of each investment fund holding at the omnibus level with the transfer agent at period end.
2. Obtain a reconciliation of the aggregated balances of all participating plans for each investment fund held by the plan to the transfer agent's omnibus account (test reconciling items as applicable) for the period end.
3. Agree plan's balances for each investment fund per record-keeping system to the amounts included in the period end listing of participating plans.
4. Test fair value by comparing the net asset value of each investment fund holding at the omnibus level to market quotations or audited financial statements.
5. Perform analytical procedures on changes in fair value of the plan's investment in the omnibus account to the overall investment fund's changes in fair value by reference to financial statements or published sources of information.

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6. Obtain a SAS No. 70 type 2 report for recordkeeper and/or transfer agent. Review, as applicable, for pertinent data relating to omnibus account and reconciliations procedures. If no SAS No. 70 report is available, consider confirming omnibus-level transactions directly with each participating plan, tracing transactions from the recordkeeper or transfer agent records to the omnibus account investment fund statements and/or other tests of transactions at the omnibus account level.

F. 103-12 Entities

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

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

A 103-12 entity is required to file the following (see paragraph A.56 of the EBP Guide):

- Form 5500
- Schedule A, “Insurance Information”

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- Schedule C, “Service Provider Information,” Part I and II
 - Schedule D, “DFE/Participating Plan Information,” Part II
 - Schedule G, “Financial Transaction Schedules”
 - Schedule H, “Financial Information” (including the Schedule of Assets (Held at End of Year))
 - A report of the independent qualified public accountant (IQPA)

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

G. What Are Derivatives? How Do I Audit Them?

Many plan sponsors continue to turn to 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 underlying¹⁶ such as changes in the price of a security or a commodity. Examples of common derivatives include call options, forward foreign exchange contracts, futures contracts, put options, and synthetic guaranteed investment contracts (GICs). 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

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16. 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.

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. Paragraph 7.56 of the EBP Guide discusses the objectives of auditing procedures applied to derivative instruments and related transactions. Paragraph 7.57 discusses the auditing procedures to be applied to derivative instruments and hedging activities.

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. 012520kk).

Help Desk—Chapter 3 of the AICPA Audit and Accounting Guide *Investment Companies* includes brief descriptions of certain financial instruments that may be helpful when such investments are used by employee benefit plans. Some derivative financial instruments commonly found in employee benefit plans include call options, forward foreign exchange contracts, futures contracts, put options, and synthetic GICs. (For more information regarding current accounting and financial reporting for synthetic GICs, see paragraphs 7.46 and 7.48 of the EBP Guide.)

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

The AICPA, working with the EBSA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans, and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of license.

Some common recurring deficiencies noted by the AICPA Peer Review Board¹⁷ 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

The EBP Guide provides guidance concerning areas where the Peer Review Board noted deficiencies.

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

Presented below is a list of auditing and attestation pronouncements and related guidance issued since the publication of last year's Alert. For information on auditing and attestation standards and related guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. For audits of issuers, such as

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¹⁷. Taken from the *AICPA 2003/2004 Peer Review Board Oversight Task Force Report and Comments*.

Form 11-K audits, see the section “For Audits of “Issuers” — Form 11-K Audits” of this Audit Risk Alert.

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’s Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

SOP 04-1 (November 2004)	<i>Auditing the Statement of Social Insurance</i>
Auditing Interpretation No. 1 of SAS No. 50 (January 2005)	“Requirement to Consult With the Continuing Accountant”
Auditing Interpretation No. 17 of SAS No. 58 (June 2004)	“Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards” (See the section “Auditing Interpretation No. 17, ‘Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards’” of this Audit Risk Alert for further details.)
Auditing Interpretation No. 18 of SAS No. 58 (June 2004)	“Reference to PCAOB Standards in an Audit Report on a Nonissuer” This Interpretation clarifies the applicability of GAAS and provides illustrative language for a dual reference reporting situation when the audit was conducted in accordance with both GAAS and the auditing standards of the Public Company Accounting Oversight Board (PCAOB).

As necessary, auditors should obtain and understand the complete text of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

Auditing Standards Available on AICPA and PCAOB Web Sites

The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA’s Audit and Attest Standards

Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

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

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

The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act dramatically affects the accounting profession and affects not just the largest accounting firms, but any CPA actively working as an auditor for a publicly traded company or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced to the business world. Although most of the provisions of this legislation are specific to auditors of public companies, even practitioners not performing audits may be affected by the Act. Therefore, all CPAs should become familiar with the provisions of the Act and the PCAOB.

Major provisions affecting employee benefit plans that file Form 11-K include the following.

- Auditors of public companies are required to register with the PCAOB. This includes auditors of employee benefit plans whose plan sponsors file annual reports on Form 11-K with the SEC.
- Auditor independence issues include the following:
 - Section 201, *Services Outside the Scope of Practice of Auditors*—The independence provisions of the Act and the SEC rules prohibit a registered firm from perform-

ing specified nonaudit services for audit clients that file with the SEC. Nonaudit services are services other than those provided in connection with an audit or a review of the financial statements.

- Section 202, *Pre-Approval Requirements*—The rule requires an audit committee to establish policies and procedures for the preapproval of services to be provided by the auditor. Preapproval policies and fee disclosures are effective for fiscal years ending after December 15, 2003.
- Section 203, *Audit Partner Rotation*—To maintain independence, partners must rotate after serving for five consecutive years and are subject to a five-year “time out” period after the rotation. This requirement also includes concurring review partners and extends to both Form 11-Ks as well as other benefit plans if there is a Form 11-K filing.
- Section 204, *Auditor Reports to Audit Committees*—Auditors are currently required to communicate specified matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, which is often the sponsor’s audit committee. SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as amended, and S-X Rule 2-07 communications need to be completed before the issuance of the audit report and filing of the Form 11-K.¹⁸

Help Desk—It should be noted that independence would be impaired if an auditor prepares financial statements for a client that are filed with the SEC.

- Corporate Responsibility
 - Section 302, *Corporate Responsibilities for Financial Reports*—This requires a certification of the financial

18. Only the Securities and Exchange Commission (SEC) required communication needs to be completed before the issuance of the Form 11-K. Other communications may occur at various times in compliance with Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as amended.

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- statements and other financial information. This requirement does not apply to annual reports on Form 11-K.
 - Section 906 certifications—Based upon discussions with the SEC, section 906 does not apply to Form 11-K filings. Plan sponsors should consult with their SEC counsel.
 - Management Assessment of Internal Controls
 - Section 404—This requires each issuer that files periodic reports with the SEC to (1) establish and maintain a system of internal control over financial reporting, (2) include in its annual report a report by management on the system of internal controls, and (3) accompany the report with an attestation report on the system of internal controls. Based upon discussions with the SEC, section 404 is not applicable to Form 11-K. Plan sponsors should consider consulting with their SEC counsel.

Audit Reports—Following Two Sets of Standards

SEC Requirements

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

Applicable Audit Standards

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

audit report that references GAAS, and the DOL will not accept an audit report that does *not* reference GAAS.

Performance and Reporting Requirements

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

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

Illustrative Opinion

The following is an example of an opinion for an 11-K audit. (When reporting on the supplemental schedules, see paragraph 13.11 in the EBP Guide for guidance.)

Report of Independent Registered Public Accounting Firm

To Participants and Administrator of the ABC 401(k) plan

We have audited the accompanying statements of net assets available for benefits of the ABC 401(k) plan (the Plan) as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United

States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2, in conformity with U.S. generally accepted accounting principles.

Reporting Considerations for Nonaccelerated Filer Audit Reports.

In an audit of a nonaccelerated filer that has determined it is not required to obtain, nor did it request the auditor to perform, an audit of internal control over financial reporting (under Section 404(b) of the Sarbanes-Oxley Act of 2002 and Item 308(b) of SEC Regulation S-K), firms may wish to consider expanding their audit report to include a statement that the purpose and extent of the auditor's consideration of internal controls over financial reporting were to determine that the nature, timing, and extent of tests to be performed are appropriate in the circumstances but were not sufficient to express an opinion on the effectiveness of internal control over financial reporting. Firms are not required to expand their audit report to include this statement. However, the SEC staff has indicated that if a firm chooses to expand its report to clarify this point, the language in Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.89-.92), provides appropriate language to consider in an audit conducted in accordance with PCAOB standards. Accordingly, the scope section of the auditor's report might be modified as follows:

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United

States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As an alternative to the first additional sentence suggested by Interpretation 18 to SAS No. 58, a firm also might consider the following:

The Plan has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting.

[This information is from the Center for Public Company Audit Firms (CPCAF)—CPCAF Alert #46- March 22, 2005.]

PCAOB Standards and Conforming Amendments

As a result of the Sarbanes-Oxley Act of 2002, both U.S. and non-U.S. public accounting firms wishing to prepare or issue reports on U.S. public companies, or to play a substantial role in the preparation or issuance of such reports, must be registered with the PCAOB and comply with the standards and rules of the PCAOB. The PCAOB's standards and rules apply to registered public accounting firms and their associated persons in connection with their audits of the financial statements of issuers, as defined in Section 2(a)(7) of the Sarbanes-Oxley Act, and those firms' auditing and related attestation practices. Plans that are required to file Form 11-Ks are deemed to be "issuers" under the Sarbanes-Oxley Act and must submit to the SEC an audit in ac-

cordance with the auditing and related professional practice standards promulgated by the PCAOB. The PCAOB does not intend to suggest that registered public accounting firms and their associated persons must comply with the PCAOB's standards and rules in auditing nonissuers. Auditors who fall within the PCAOB's scope should understand and follow the standards, rules, and other requirements of the PCAOB. All PCAOB standards and rules must be approved by the SEC before taking effect.

Presented below is a list of PCAOB auditing standards and other rules issued since the publication of last year's Alert. For information on auditing standards and related guidance issued subsequent to the writing of this Alert, please refer to the PCAOB Web site at www.pcaobus.org (audits of issuers only).

PCAOB Auditing
Standard No. 1
(May 2004)

References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board
This standard requires that auditors' reports on engagements conducted in accordance with PCAOB standards include a reference that the engagement was conducted in accordance with those standards. The rule replaces previously required references to GAAS. It also adopted technical amendments to its rules on interim standards that referred to existing professional standards of auditing, attestation, quality control, ethics, and independence. This standard is effective beginning May 24, 2004. (See the section "Audit Reports—Following Two Sets of Standards" in this Alert for further guidance for Form 11-K audits)

PCAOB Auditing
Standard No. 2
(June 2004)

An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements
This standard addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. This standard is effective for audits of companies with fiscal years ending on or after November 15, 2004, for accelerated filers, or July 15, 2005, for other companies. Form 11-K does not require a 302 certification. Although the rule is silent regarding Rule 404 reports, the SEC staff had agreed that because Form 11-K filers are not subject to Item 308 of Regulation S-K, the Form 11-K need not

PCAOB Auditing
Standard No. 3
(August 2004)

PCAOB Release 2004-008
(November 2004)
See the PCAOB Web site
at www.pcaobus.org for
information about the
effective date of these
conforming amendments.

PCAOB Rules
(Various dates)

include a 404 report.¹⁹ Accordingly, Form 11-K filers do not need to have an audit of internal control over financial reporting in accordance with PCAOB Auditing Standard No. 2.

Audit Documentation

This standard establishes general requirements for documentation an auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB. This standard is effective for audits of financial statements of companies with fiscal years ending on or after November 15, 2004.

Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2

The PCAOB had adopted as interim standards, on an initial, transitional basis, the AICPA generally accepted auditing standards in existence on April 16, 2003. PCAOB Release 2004-008 amends certain of these interim standards resulting from the adoption of PCAOB Auditing Standard No. 2. While Form 11-K filers may not have to follow PCAOB Auditing Standard No. 2, as noted above, certain of the provisions in Release 2004-008 are relevant to situations in which an auditor is engaged solely to audit a company's financial statements and not just when performing an integrated audit of financial statements and internal control over financial reporting. Therefore, certain of these conforming amendments should be followed. The EBP Guide reflects these conforming amendments, as appropriate.

In the past year the PCAOB has issued numerous rules to be used by registered public accounting firms in the preparation and issuance of audit reports. (See the AICPA Audit Risk Alert *Audit Risk Alert 2004/05* (product no. 022335) or the PCAOB Web site at www.pcaobus.org for further information.)

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19. This information was taken from the AICPA SEC Regulations Committee highlights. The AICPA SEC Regulations Committee meets periodically with the SEC staff to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. This information has not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization. In addition, they are not authoritative positions or interpretations issued by the SEC or its staff. They were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, they do not constitute an official statement of the views of the SEC or of the staff of the SEC. Be alert to changes in this position by monitoring the SEC Regulations Committee Web site at www.aicpa.org.

PCAOB Staff Questions

1. *Auditing Internal Control Over Financial Reporting*. These questions and answers have been updated by the PCAOB staff since their original release. Additional guidance has been provided about issues surrounding the involvement of service organizations in the assessment of the effectiveness of internal control over financial reporting under PCAOB Auditing Standard No. 2.

2. *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the PCAOB*.

Suggested Framework for Internal Controls related to PCAOB Auditing Standard No. 2

A Framework for Evaluating Process/

Transaction-Level Exceptions and Deficiencies

Developed by representatives of nine firms and a professor, this framework reflects their views on a methodology consistent with their understanding of PCAOB Auditing Standard No. 2. The framework can be obtained at www.aicpa.org/cpcf/download/framework.pdf.

Auditing Pipeline—Public Companies

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

Accounting Developments

SOP 94-4 and Accounting for Fully Benefit Responsive Investment Contracts

Recently there has been interest in the guidance contained in AICPA SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Plans and Defined-Contribution Pension Plans*, as it relates to investment companies. Since at least the mid-1990s, registered and nonregistered investment companies,²⁰ often

20. The AICPA Audit and Accounting Guide *Audits of Investment Companies* defines a *registered investment company* as an entity “that has filed a registration statement with the SEC as an investment company in accordance with the requirements of the Investment Company Act of 1940.” The term *nonregistered investment company* is used to describe an investment company that is exempt from registration under the SEC rules. Nonregistered investment companies include common trust funds and collective investment funds. Stable value funds may be registered with the SEC or exempt from registration.

referred to as stable value funds, have reported fully benefit-responsive investment contracts at contract value. The accounting for such contracts at contract value was based on the premise that SOP 94-4 allows employee benefit plans under its scope to report their indirect investments in fully benefit-responsive investment contracts through pooled investment vehicles at contract value, which may or may not approximate fair value. Some have taken the position that the contract value of fully benefit-responsive investment contracts has historically approximated fair value or by analogy to SOP 94-4.

In light of recent interest in the guidance contained in SOP 94-4, this section reviews the requirements of the SOP as it relates to employee benefit plans.

SOP 94-4 says that defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution plans, including both health and welfare and pension plans, should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value, and all other investment contracts at fair value. If, however, plan management is aware that an event has occurred that may affect the value of a fully benefit-responsive contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate.²¹

The reasoning behind this accounting is explained in SOP 94-4. The primary objective of a defined-contribution plan's financial statements is to provide information that is useful in assessing the

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21. Health and welfare benefit plans and defined-contribution pension plans should report insurance contracts in the same manner as required by ERISA annual reporting requirements of DOL Form 5500 or 5500-C/R. For purposes of this SOP, the terms *insurance contract* and *investment contract* are used as those terms are described for accounting purposes in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (see paragraphs .13 and .14).

plan's present and future ability to pay benefits when they are due. In a defined-contribution plan, the plan's net assets available to pay benefits equal the sum of participants' individual account balances. Accordingly, benefits that can be paid by the plan when they are due relate to the value of the assets that may currently be made available to the individual participants. Information that is useful to plan participants includes the amount they would receive currently if they were to withdraw or borrow funds from or transfer funds within the plan.

If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit responsive.

Contributions Receivable

Contributions Receivable—Defined Benefit Pension Plans

Many times the funding of the final and possibly additional contributions for defined benefit plans occurs after a plan's year end. Auditors are often unsure of how to treat contributions made after the plan's year end but before the filing of the plan's Form 5500. Plan sponsors have until the date the plan sponsor's tax return is due to make contributions and apply them to the previous year.

Guidance for contributions receivable can be found in Chapter 2 and Chapter 8, paragraph 8.05, of the EBP Guide. Based on this guidance, determining how to treat contributions made after the plan year is as follows: (1) Inquire of the plan sponsor to understand the timing of any additional contributions anticipated to be made after the plan year end that will be included on the plan sponsor's tax return for the year under audit; (2) before issuing the auditor's report, obtain the Form 5500 Schedule B from the actuary to ensure that the contributions reported on Schedule B agree to the amount included in the plan's financial statements and Schedule H. This practice will, in many instances, result in

filing the Form 5500 after September 15 for calendar year-end defined benefit pension plans.

In the event that the financial statements and related Form 5500 were already filed and the plan sponsor elects to make an additional contribution related to the year under audit, this additional contribution should be treated as a subsequent event. A footnote should be added to the financial statements including information reconciling the contributions per the financial statements to the Form 5500. The Form 5500 should then be amended and refiled. The auditor's opinion should be dual dated for the subsequent event. Financial statements should not be restated unless an error has occurred. For further guidance, see the EBP Guide, paragraphs 12.32 and 12.33.

Contributions Receivable—Health and Welfare Plans

Health and welfare plans typically pay claims on a pay-as-you-go basis. Based on this funding policy, a receivable for incurred but not reported (IBNR) claims is generally not recorded. IBNR claims are an estimate and are not paid until submitted. An argument could be made for recording a receivable for claims payable and premiums payable because these amounts are known and are short term in nature.

New Accounting Pronouncements and Other Guidance

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

FASB Statement No. 132
(revised 2003)
(December 2003)

*Employers' Disclosures about Pensions and Other
Postretirement Benefits—an Amendment of FASB
Statements No. 87, 88, and 106*

This Statement revises employers' disclosures about pension plans and other postretirement benefit plans by requiring additional disclosures to those in

	the original Statement 132 about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans.
FASB Interpretation No. 46(R) (December 2003)	<i>Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of Accounting Research Bulletin No. 51</i>
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). See the section “Effects of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 on Plans” for a discussion of FSP FAS 106-2.
SOP 03-4 (December 2003)	<i>Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide, Audits of Investment Companies, and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships</i>
SOP 03-5 (December 2003)	<i>Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide, Audits of Investment Companies</i>
SOP 04-2 (December 2004)	<i>Accounting for Real Estate Time-Sharing Transactions</i>
AICPA Practice Aid (May 2004) (nonauthoritative)	<i>Valuation of Privately Held Company Equity Securities Issued as Compensation</i> This Practice Aid provides useful information on measuring the cost of such transactions and properly reflecting them in company financial statements.

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Audit and Accounting Guide Revisions as of March 1, 2005

The following list summarizes some of the revisions included in the EBP Guide, with conforming changes as of March 1, 2005.

The EBP Guide has been updated to reflect the following:

- HIPAA considerations
- New SAS No. 70 guidance
- Omnibus accounts
- AICPA Auditing Interpretation No. 17, “Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards,” of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.85–.88)
- PCAOB Auditing Standard No. 1, *References in Auditor’s Reports to the Standards of the Public Company Accounting Oversight Board*
- PCAOB Auditing Standard No. 3, *Audit Documentation and Amendment to Interim Auditing Standards*
- PCAOB Release 2004-2008, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*

Help Desk—To order the Audit and Accounting Guide *Employee Benefit Plans*, call the Service Center Operations at (888) 777-7077 or go to www.cpa2biz.com and order product no. 012595kk.

AICPA Professional Ethics Division Interpretations and Rulings

Ethics Interpretations and rulings are promulgated by the executive committee of the Professional Ethics Division of the AICPA

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

Help Desk—It is important for you to monitor the activities of the Professional Ethics Executive Committee because it may issue Interpretations, ethics rulings, or both, that may be relevant to your engagements. 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 5, 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.88 in Appendix A of the EBP Guide for a listing of the DOL's independence standards.

The AICPA has published a new risk alert *Independence and Ethics Alert—2004/05* (product no. 022475kk). See this alert for further guidance on ethics and independence matters.

On the Horizon

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

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

These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB) (Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/members/div/auditsd/drafts.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
AICPA Accounting Standards Executive Committee (AcSEC)	http://www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Auditing Pipeline—Nonissuers

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

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

Seven SASs Related to Audit Risk Proposed

In December 2002, the AICPA’s Auditing Standards Board (ASB) issued an exposure draft proposing seven new SASs relating to the auditor’s risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the pro-

posed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opin-

ion regarding the financial statements under audit. Readers should be alert for the issuance of final standards in 2005.

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

This proposed SAS will supercede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in 2005.

Proposed SAS, *Audit Documentation*

This proposed SAS will supersede SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and establish standards and provide guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on. Audit documentation is an essential element of audit quality. Although audit documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate audit documentation contributes to the quality of an audit. The ASB believes this exposure draft is responsive to the issues that have been raised in the U.S. nonissuer community and will improve audit practice and serve the public interest.

In developing this exposure draft, the ASB considered the documentation requirements of the PCAOB's Auditing Standard No. 3, *Audit Documentation*; the International Auditing and Assurance Standards Board's exposure draft, ISA 230, *Audit Documentation*, issued in September 2004; suggestions received from the National Association of State Boards of Accountancy; and Government Auditing Standards issued by the Comptroller General of the United States.

In addition to the proposed SAS, the exposure draft includes proposed amendments to SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 530.01 and .05, "Dating of the Independent Auditor's Re-

port”). The proposed amendment requires that the auditor’s report not be dated earlier than the date on which the auditor has obtained sufficient competent audit evidence to support the opinion on the financial statements. It also proposes an amendment to SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.05). The amendment adds a requirement for the auditor to document his or her justification for a departure from the SASs in the working papers. The comment period for this exposure draft ends on May 15, 2005.

Proposed SAS, *Defining Professional Requirements in Statements on Auditing Standards*, and Proposed Statement on Standards for Attestation Engagements, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*

The ASB has issued an exposure draft of a proposed SAS entitled *Defining Professional Requirements in Statements on Auditing Standards* and a proposed Statement on Standards for Attestation Engagements (SSAE) entitled *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. The proposed SAS and SSAE define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner.

Proposed SSAE, *Reporting on an Entity’s Internal Control Over Financial Reporting* (AT sec. 501)

This Statement establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity’s internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity’s internal control and the prohibition of acceptance of an engagement to review such subject matter.
- Engagements to examine the design and operating effectiveness of an entity’s internal control.

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- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable).
 - Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control).
 - Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency.

Readers should be alert for the issuance of a final standard in 2005.

Accounting Pipeline

Proposed FASB Statement, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140*

This proposed Statement would amend and clarify FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in several ways. The initial exposure draft for this proposed Statement was issued in June 2003. However, in response to several comment letters, the FASB began redeliberations on the issues raised. Readers should be alert for the issuance of a revised exposure draft, which is expected to occur in the second quarter of 2005. In addition, the FASB will be issuing two additional exposure drafts pertaining to FASB Statement No. 140 also in the second quarter of 2005. The exposure drafts will pertain to beneficial interests in securitized financial assets and servicing rights. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95*

This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for

using a fair-value-based method. In October 2004, the FASB approved a six-month delay in the options expensing rule, to June 15, 2005. This accounting proposal is engulfed in highly charged political debate, and as such, the ultimate resolution of share-based compensation accounting remains uncertain. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Fair Value Measurements*

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected to occur in the first quarter of 2005. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statements Resulting From Short-Term International Convergence Project

In an effort to reduce or eliminate certain differences between U.S. GAAP and international financial reporting standards (IFRS), the FASB issued exposure drafts on the proposed FASB Statements listed below. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Accounting Changes and Error Correction—a replacement of APB Opinion No. 20 and FASB Statement No. 3*

This proposed Statement would change the reporting of certain accounting changes specified in APB Opinion No. 20, *Accounting Changes*, by requiring retrospective application of a newly adopted accounting policy for most changes in accounting principle, including changes in accounting principle required by issuance of new pronouncements. It would also require reporting of a change in depreciation, amortization, or

Proposed FASB Statement,
*Earnings per Share—an
amendment of FASB
Statement No. 128*

depletion method as a change in accounting estimate. Readers should be alert for the issuance of a final Statement, which is expected to be released in the second quarter of 2005.

This proposed Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the Treasury stock method. Also, this proposed Statement would eliminate the provisions of Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final Statement, which is expected to be released in the third quarter of 2005.

Proposed FASB EITF Issues

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

Proposed FASB Staff Positions

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

International Accounting Standards

The International Accounting Standards 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 (IASs).

Employee Benefit Plan-Related Standards

The following are employee benefit plan-related standards or projects:

- 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.
- Exposure draft of a proposed amendment to IAS No. 19, *Employee Benefits: The Asset Ceiling*
- Exposure draft of a draft interpretation of IAS No. 19, *Employee Benefits: Multi-employer Plan Exemption*
- In June 2002 the IASB agreed to add a limited convergence project on postemployment benefits to its agenda. The purpose of this project was to build on the principles that are common to most existing national standards on postemployment benefits and to seek improvements to IAS No. 19 in certain specific areas. At the joint IASB/FASB meeting in April 2004, the boards agreed to undertake a joint comprehensive project on postemployment benefits when staff resources permitted. The IASB also agreed in the short-term to develop an exposure draft with interim proposals on the recognition of actuarial gains and losses, proposals on the treatment of group defined benefit plans in the individual or separate financial statements of entities within a consolidated group, and additional disclosures. That exposure draft was published in April 2004 with a comment deadline of July 31, 2004. Final amendments were published in December 2004.
- In April 2004 the IASB published an exposure draft of proposals on aspects of pension cost accounting, in particular giving entities an option to show, in full, pension deficits and available surpluses. This proposal is similar to

the requirements of the U.K. standard, FRS 17, *Retirement Benefits*. Approval of this proposed option would enable companies that already show the surplus or deficit in full under FRS 17 and are adopting International Financial Reporting Standards (IFRSs) to continue with their present policy. The exposure draft also includes proposals:

- To extend the application of multiemployer plan accounting to entities within a consolidated group that meet specified criteria.
- For additional disclosures.
- The IASB is also considering undertaking a comprehensive project on postemployment benefits, looking at fundamental aspects of measurement and recognition. Until the outcome of such a broader review of the accounting for postemployment benefits, the IASB would continue to permit the option under IAS No. 19, *Employee Benefits*, to recognize actuarial gains and losses (that is, unexpected changes in value of the plan) in profit or loss, either in the period in which they occur or spread over the service lives of the employees. Almost all entities currently using IAS No. 19 choose to spread actuarial gains and losses.

Help Desk—For further information regarding the IASB and its standards, visit its Web site at www.iasb.org.uk.

Resource Central

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

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.

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- AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (product no. 012595kk).
 - Updated! *Accounting Trends & Techniques—Employee Benefit Plans, second edition* (product no. 006624kk). Offering the same kind of powerful help that the AICPA's *Accounting Trends and Techniques* does, this comprehensive book illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The publication also includes a chapter dedicated to illustrative management letters and management letter comments.
 - New! *SAS No. 70 Reports and Employee Benefit Plan* (product no. 061061kk, available July 31, 2005). In practice, auditors of employee benefit plans have continued to raise questions about how SAS No. 70 reports should be considered in their audits and the auditing procedures that should be applied to these reports to increase their reliability as audit evidence. This publication provides you with guidance on the use of SAS No. 70 reports in your employee benefit plan audits. Specifically, this publication is designed to address issues relating to:
 - The circumstances under which a SAS No. 70 report should be obtained
 - How SAS No. 70 reports should be considered in a limited-scope audit
 - The implications of sub-service arrangements
 - How to read and understand how a SAS No. 70 report affects your audit, including the procedures you should perform to understand the scope of the service auditor's work, whether that scope is adequate for your purpose, and the procedures you should perform to evaluate the results of tests of controls
 - How to develop an appropriate audit response for identified testing exceptions and control deficiencies

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- Checklists and Illustrative Financial Statements for:
 - *Defined Benefit Pension Plans* (008994kk). The 2005 checklist will be available this summer (product no. 008995kk).
 - *Defined Contribution Pension Plans* (009004kk). The 2005 checklist will be available this summer (product no. 009005kk).
 - *Health and Welfare Benefit Plans* (009014kk). The 2005 checklist will be available this summer (product no. 009015kk).
 - *Governmental Employee Benefit Plans* (published February 2004, product no. 009043). This checklist will be integrated into the state and local governmental units checklist available this summer.
 - *A Wake-Up Call*, an employee benefit plan audit video (013801kk).

AICPA's reSOURCE Online Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.

reSOURCE CD-ROM

The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access in Windows format to AICPA professional literature products, namely, *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.

Web Casts

June 7, 2005—*Form 5500: Qs & As With the DOL*. This new Web cast will address some of the common errors when preparing the Form 5500, discuss a number of frequently asked questions about the Form 5500, and provide Web cast participants with the opportunity to pose their own questions to our panel of experts from the DOL and CPA practitioners.

June 30, 2005—*Strategic Industry Briefing—Employee Benefit Plans*. This AICPA strategic briefing will address current industry developments and emerging practice issues relating to employee benefit plans. Participants will learn about current accounting, auditing, and regulatory developments, including the impact of recently issued pronouncements on both preparers and auditors of employee benefit plans. Speakers include Marcus J. Aron, CPA; Marilee Lau, CPA; and Alice Wunderlich, CPA. [Level: Intermediate. Recommended CPE credit (based on a 50-minute hour): 2]

Conferences

National Conference on Employee Benefit Plans

Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and plan sponsors on various topics, including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2006 National Conference on Employee Benefit Plans will be held May 8 through 10, 2006, in Baltimore, Maryland. For a conference brochure, please call (888) 777-7077, and request brochure G50038; for more information, visit the Web site at www.cpa2biz.com/conferences.

Education Courses

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

- Audits of Employee Benefit Plans
- Audits of 401(k) Plans

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz, is AICPA's flagship online learning product. *AICPA InfoBytes* now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- to two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit <http://cpa2biz.com>.

CPE CD-ROM

AICPA's Standards Update and Implementation Guide (formerly *The Practitioner's Update*) (product no. 738462kk) 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.

Service Center Operations

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

Hotlines

Accounting and Auditing Technical Hotline

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

Ethics Hotline

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

Web Sites

AICPA Online and CPA2Biz

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

Other Helpful Web Sites

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

This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2004*.

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>2005</i>	<i>2004</i>	<i>2003</i>
Defined benefit			
Maximum annual pension	\$170,000	\$165,000	\$160,000
Defined contribution			
Maximum annual addition	42,000	41,000	\$40,000
401(k) plan			
Maximum elective deferral ¹	14,000	13,000	\$12,000
403(b) plan			
Maximum elective deferral	14,000	13,000	\$12,000
457 plans	14,000	13,000	\$12,000
SIMPLE plans	10,000	9,000	\$8,000
Qualified plans			
Maximum compensation limits	210,000	205,000	\$200,000
Highly compensated limits	95,000	90,000	\$90,000
Officer limits (key employee)	135,000	130,000	\$130,000
FICA taxable wage base	90,000	87,900	\$87,000
Employer and employee Social Security tax	6.20 percent	6.20 percent	6.20 percent

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1. Catch-up contributions for individuals over age 50 increased to \$2,000 in 2003, to \$3,000 in 2004, and to \$4,000 in 2005.

Commonly Asked Questions and Answers

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

EBP-Related Technical Practice Aids

Auditing

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

The auditor should apply appropriate audit tests and procedures to the opening balances in the Statement of Net Assets

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

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

2. How should the auditor test for proper investment allocation in situations where changes may be made by participants electronically, via phone or Internet, on a daily basis?
 - A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), the auditor should consider confirming the contribution percentage, source, and investment election directly with the participant, or compare that information to detail of the transaction (for example, a copy of the transaction confirmation) if maintained by the plan sponsor or service provider. Alternatively, if a service provider has a type 2 SAS No. 70 report that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce (not eliminate) substantive testing.

(Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005, paragraph 7.16.)

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

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

4. What procedures need to be performed in audits where the plan doesn't receive a SAS No. 70 report from the service provider?
 - A. Service providers are not required to furnish SAS No. 70 reports. However, this does not relieve the auditor of his or her responsibility to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed by considering those components of internal control maintained by the service organization. In situations where a SAS No. 70 report is

not available, other sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports on the service organization's controls issued by internal auditors or regulatory authorities, may provide sufficient information about the nature of the services provided by the service organization that are part of the user organization's information system and the service organizations controls over those services. If both the services provided and the service organization's controls over those services are highly standardized, information obtained through the plan auditor's prior experience with the service organization may be helpful in planning the audit. The plan auditor may wish to consider the specific control objectives and selected controls outlined in Exhibit B-1 of Appendix B of the AICPA Accounting and Audit Guide *Employee Benefit Plans*, in obtaining his or her understanding. If the user auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to plan the audit, consideration should be given to contacting the service organization through the user organization to obtain adequate internal control information, or request that a service auditor be engaged to perform procedures at the service organization.

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

Auditing procedures applied to data maintained by the service provider may include tests of participant data, payroll data, or benefits data to determine that they agree with the information obtained and maintained by the employer. If the data is not available at the employer, consideration should be given to confirming the information directly with participants or to reviewing hard copy information obtained from the service provider, if available.

Individual participant accounts in 401(k) plans or other defined contribution pension plans should be tested for proper allocation of plan assets, contributions, income, and expenses. As such, the auditor should consider confirming contribution percentages and investment elections directly with the participants in situations where transactions are performed electronically or by phone. In addition, record-keepers may maintain back up documentation of participant transactions, which may be requested as audit evidence to test participant data.

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

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

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

A commonly used method of testing this information is comparing the yield in the participants' accounts (selecting a sample of funds) for a certain period of time to the yield that the plan reported as a whole (as compared to published sources) for those funds for the same period of time.

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

In performing a full scope audit, an auditor may use the SAS No. 70 report to obtain information about the controls at the service organization to assess control risk and design methods of testing the investment information. In accordance with SAS No. 57, *Auditing Accounting Estimates*, the auditor should test fair values by reference to market quotations or other evidence of fair value. Frequently, a SAS No. 70 report will address the value of marketable securities, but will not address the market value of nonmarketable investments, such as real estate and limited partnerships. If the SAS No. 70 report covers pricing of investments for specific assets that the plan holds, an auditor may be able to rely on it to reduce, but not eliminate, the extent of substantive testing in that area.

7. How much reliance can be placed on the SAS No. 70 report? The AICPA EBP Guide says that the SAS No. 70 report may only be used to reduce testing, not eliminate it. However, I heard at a conference that with an appropriate SAS No. 70 report, substantive testing may be eliminated. What is the correct answer?

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- A. Testing may be reduced if the SAS No. 70 report addresses a specific audit area and the controls around it appear satisfactory, but testing may not be eliminated entirely.

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

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

8. What is the auditor's responsibility for testing a plan's compliance with top heavy rules, the Average Deferral Percentage Test, and other qualification issues?
- A. An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, a plan must be designed to comply with all provisions, and must meet certain operating tests in order to maintain its qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations of provisions that may affect the financial statements, he or she should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor also is expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations, and the controls in place to prevent violations of those laws and regulations that may cause the plan to lose its qualified status.

(Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005, Chapter 11 and paragraphs 12.01 through 12.03.)

9. In recent audits of health and welfare plans, our firm has been denied access to personnel files because of Health Insurance Portability and Accountability Act of 1996 (HIPAA) rules. In such cases, it has prohibited us from performing certain procedures necessary to render our opinion on the financial statements, such as testing of birth date, hire date, elections, and other such information. How can we overcome this obstacle?
- A. The items mentioned (birth date, hire date, elections) are not “protected health information” (PHI) under the HIPAA rules.

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

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

HIPAA privacy regulations indicate that a plan sponsor may not use or disclose protected health information except as permitted or required by the regulations. The regulations permit use of the “minimum necessary” information for use in health care operations, including conducting audits. If

the auditor has signed a business associate agreement with the plan sponsor, then that auditor is considered a business associate under the regulations, and access to such minimum necessary information required for the audit should not be restricted by HIPAA.

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

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

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

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

11. For the year ended December 31, 2002, an audit was performed for AB Plan with more than 100 participants that covered two related companies (Company A and Company

B). In July 2003, Company A was sold, and the plan assets related to those participants were transferred to a new plan (Plan C). What are the audit requirements for the remaining portion of the AB Plan which, as of July 2003, cover only employees at Company B and had fewer than 100 participants?

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

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

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

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

13. If a defined contribution plan has an effective merger date, per the merger agreement, of December 31, 2003, but a significant portion of the plan's assets have not been transferred

as of December 31, 2003, should the audit be done as of the December date, or when the majority of the assets were transferred? Would the answer be any different for a defined benefit plan? Would a liability representing the assets due to the acquiring plan be reflected on the statement of net assets if the audit date is December 31, 2003?

- A. For defined contribution plans, if there is a significant difference between the effective merger date per the merger agreement and the actual date of transfer of assets, consideration should be given to performing an audit through the date of the actual transfer. However, all facts and circumstances should be considered, including management's intent, before determining the proper merger date.

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

Auditor's Reports

14. In situations where the plan has no audit committee, but the plan sponsor has an audit committee, are the plan auditors required to issue an audit committee letter? What is the requirement if the plan has an administrative committee? Would the answer be different for public and nonpublic entities?
- A. SAS No. 61, *Communication With Audit Committees* (as amended by SASs No. 89, *Audit Adjustments*, and No. 90, *Audit Committee Communications*), requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. The communications are to be made to an audit committee or to a group equivalent to an audit committee which has formal desig-

nated oversight responsibility of the financial reporting process, such as a finance committee or budget committee. For employee benefit plans, formal oversight may be delegated to a pension or administrative committee.

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

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

Nonpublic entities. Plans that do not file a Form 11-k with the SEC are considered nonpublic entities. If a plan that does not file a Form 11-k with the SEC has no designated group or body equivalent to an audit committee with formal responsibility for the financial reporting process, the auditor is not required to make the communications required by SAS No. 61, as amended.

Public entities. Plans that file a Form 11-k with the SEC are considered public entities. For such plans, the communications required by SAS No. 61 (as amended by SASs No. 89 and No. 90) must be made in every situation. When issuing an audit report on financial statements that are filed with the SEC, auditors are required to follow Rule 2-07 of Regulation S-X in addition to the matters required to be communicated to the audit committee by SAS No. 61, as amended.

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

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

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

15. We have completed the audit of a plan except for reviewing the 401(k) and 401(m) discrimination testing, which has not yet been done and, quite possibly may not ever be done. If such testing is not performed, what type of audit opinion should be issued?
- A. Independent auditors should inquire if the plan has complied with the annual limitation tests to determine if the plan has met the requirements in order to maintain its tax exempt status. Since the nondiscrimination requirements under 401(k) and 401(m) are required to be met annually, the independent auditor should understand the results of similar tests performed in the past and the reasons why the associated testing has not been performed in the current year. The auditor should be aware that any corrections, corrective distributions, or qualified nonelective contributions (QNECs) that would result from failure of these compliance tests must be made before the end of the following plan year to preserve the plan's qualified status. If correction is to be made through refunds, then a correction made within 2 ½ months after the plan's year end will avoid potential excise tax and preserve the plan's qualified tax status. In contrast, a refund after 2 ½ months triggers an excise tax payable by the plan sponsor. In the event that testing has not been completed for the year under audit, the auditor should consider the results of testing performed in the past, any corrections that were made, and whether significant changes in the plan's demographics have occurred. The client should determine whether or not it is expected that a correction will be necessary, and should make an estimate for accrual purposes

of the amount required for correction. Consideration should be given to modifying the tax note in the financial statements to indicate that the plan sponsor will take the necessary steps, if any, to bring the plan's operations into compliance with the Code. Similar wording also should be included in the management representation letter. If the results of the testing, when completed, are expected to be material based on similar issues in the past or discussions with the client and a correction amount cannot be reasonably estimated, the auditor should consider withholding his or her report until the testing is completed and the appropriate accruals recorded. If, however, the financial statements are issued and the client doesn't remedy or complete the tests by the next audit, the auditor should consider the effect on the financial statements as well as other implications as described in SAS No. 54, *Illegal Acts by Clients*, since the plan's tax qualified status may be in jeopardy.

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

Sale of Real Estate Investments Held by Employee Benefit Plans

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

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

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

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

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

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

- A. No. For many entities, after evaluating the conditions in paragraph 42 of FASB Statement No. 144, an investment in real estate (such as a building) that generates rental income and operating expenses would be considered to meet the definition of a “component of an entity” (as defined in FASB Statement No. 144) and, therefore, any gains or losses relating to the disposal of that “component” would be reported in discontinued operations. However, employee benefit plan financial statements show financial status or net assets available for benefits and changes in financial status or net assets

available for benefits. Because they do not show a statement of operations or activities, there is no reason to distinguish between continuing and discontinued operations. Rather, real estate in an employee benefit plan should be treated as an investment carried at fair value and the related income/expenses and net appreciation/depreciation should be included in the statement of changes in financial status or statement of changes in net assets available for benefits. No distinction should be made between continuing and discontinued operations.

(TPA Section 6930.05—Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations)

Other Commonly Asked Questions

Employee Benefit Security Administration Guidance on Insurance Company Demutualizations

1. During the past few years there have been a number of insurance companies that have demutualized, resulting in the insurance contract policyholder receiving demutualization proceeds. What alternatives are available with respect to receipt by policyholders of demutualization proceeds?
 - A. On February 15, 2001, Employee Benefit Security Administration (EBSA) issued a letter regarding alternatives available under the trust requirement of Title I of ERISA with respect to receipt by policyholders of demutualization proceeds belonging to an ERISA-covered plan in connection with the proposed plan of demutualization of an insurance company (the company). In its letter, the DOL noted that the application of ERISA's trust requirements would depend on whether demutualization proceeds received by a policyholder constitute plan assets. The DOL stated that, in the case of an unfunded or insured welfare plan in which participants pay a portion of the premiums, the portion of the demutualization proceeds attributable to participant contributions must be treated as plan assets. In the case of a pension plan, or where any type of plan or trust is the policyholder or where

the policy is paid for out of trust assets, the DOL stated that all of the proceeds received by the policyholder in connection with the demutualization would constitute plan assets. Auditors should take care to identify those plans with contracts with insurance companies that have demutualized and ensure that the proceeds are properly recorded as plan assets. Plan sponsors may not be familiar with EBSA's letter regarding alternatives available with respect to receipt by policyholders of demutualization proceeds. In addition, it has been noted that demutualization proceeds are often deposited into a separate account or trust and may be overlooked in financial reporting for the plan.

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

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

Other Questions

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

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- A. According to the U.S. Department of Labor (DOL), such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee's behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited-scope report to include reference to such an arrangement. Sample language might include the following: "any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan, . . . We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate." The third paragraph of the report should also be modified.
4. Is it permissible to perform a limited-scope audit on a portion of the plan's investments but not all (some investments did not meet the DOL 29 CFR 2520.103-8 criteria for a limited-scope audit)? If yes, what form does the auditors' report take?
- A. Yes, it is permissible to perform a limited-scope audit on only a portion of a plan's investments and audit the remaining investments. The auditors' report is the same as that used for a limited-scope audit. However, the note that is referenced in the auditor report should clearly identify the investments that were not audited.
5. Under Form 5500 (Schedule H, Part IV, line 4j), there is a special rule whereby transactions under an individual account plan that a participant directs should not be taken into account for purposes of preparing the Schedule of Reportable Transactions. What about situations where an individual account plan is participant-directed but has certain

transactions that appear to be nonparticipant-directed (for example, pass-through account for contributions)?

- A. If the plan is an individual account plan and the overall structure of the plan is participant-directed, pass-through account transactions would not be required to be included on the Schedule of Reportable Transactions. Another example would be a participant-directed individual account plan that liquidates its investment options as a result of a plan termination, merger, or change in service provider. Often such changes result in the plan sponsor directing the plan trustee to liquidate the current balance in the participant-directed investment options into a short-term fund before the transfer to new investment options. Such transactions would be not be required to be included on the Schedule of Reportable Transactions.
6. What are the general conditions requiring an audit of pension plan financial statements?
- A. An audit generally is required if the plan is covered under Title I of ERISA and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in Chapter 5 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (the EBP Guide) provides guidance on determining who is considered a participant. In addition, DOL regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category (“large plan” or “small plan”) as was filed in the previous year.
7. What audit procedures should be performed on material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?
- A. If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance 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 12.13 through 12.16 of the EBP Guide.)

8. When a plan operates in a decentralized environment, what additional audit procedures should be considered?
 - A. The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.
9. When the majority of a plan's assets are held in a master trust, but the plan has investments outside of the master trust, what are the requirements for the supplemental schedules?
 - A. The Form 5500 instructions exclude master trust assets from the supplemental schedule reporting requirements. However, any assets held outside the master trust must be reported on the supplemental schedules. When calculating the 5 percent threshold for disclosing reportable transactions, the current value of master trust assets is subtracted from the beginning of the year net asset balance.
10. Is the master trust required to be audited?
 - A. While the DOL does not require the master trust to be audited, the plan administrator normally engages an auditor to report only on the financial statements of the individual plans. If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement asser-

tions as to the plan's investments or qualify or disclaim his or her report.

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

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

12. Should noninterest-bearing cash be included as an asset on the supplemental Schedule of Assets (Held at End of Year)?

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

13. Can immaterial investments be netted together as "other" on the supplemental Schedule of Assets (Held at End of Year)?

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

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

A. An audit performed in accordance with generally accepted auditing standards (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, during the audit the auditor should be aware of the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire about the existence of any party-in-interest or nonexempt transactions. If any issues relating to late remittances are brought to the auditor's attention, the auditor may consider obtaining a schedule of employee contribu-

tions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.

15. If a nonexempt transaction related to the above is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of nonexempt transactions?
 - A. There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.
16. When is a plan subject to the requirements of the Securities Act of 1933, thus requiring a Form 11-K filing under the Securities Exchange Act of 1934?
 - A. Section 3(a)(2) of the Securities Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements, provided they are both voluntary and contributory. (For further guidance, see paragraph 12.24 of the EBP Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.
17. In a defined contribution plan, can investments be shown as a one-line item on the financial statements?
 - A. Participant-directed plan investments may be shown in the aggregate, as a one-line item in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investment companies, government securities, corporate bonds, common stocks, and so on.

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

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

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

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- A. If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.
27. If multiple plans use a VEBA trust, can an audit be performed at the VEBA trust level?
- A. The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.
28. Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?
- A. If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.
29. What responsibility does the auditor have in testing plan qualification tests (for example, ACP and ADP) prepared by a client's third-party administrator?
- A. An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, plans must be designed and comply with certain operating tests to maintain their qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor is also expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations and the prevention of violations that may cause disqualification.

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30. If the plan fails its 20X0 discrimination test and has to return employee contributions in 20X1, should “excess contribution payable” liability be shown on the 20X0 financial statement?
- A. Yes, the financial statements should reflect a liability for excess contributions payable on the financial statements if the amount is material to the financial statements.
31. What alternate audit procedures should be done to test participants’ investment allocation of deferral contributions where no documentation exists (participants can change deferrals and allocation of such online or via phone)?
- A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), consider confirming contribution percentage, source, and investment election directly with the participant or compare to a transaction report, if one is maintained. Alternatively, if the service provider has a type 2 SAS No. 70 report¹ that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce (not eliminate) substantive testing.
32. For a DOL limited-scope audit, is it necessary to test the allocation of investment earnings at the participant account level?
- A. The testing of allocation of investment earnings at the participant level is part of the participant data testing and is recommended for a limited-scope audit.
33. Brokerage accounts can be listed on one line item on the Form 5500. Can they be listed on one line item on the supplemental schedules to the financial statements, or do the individual underlying investments have to be listed?
- A. As described in the Form 5500 instructions, individually directed brokerage accounts may be listed as one line item on the statement of net assets available for benefits and on the

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1. Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended.

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

34. When a defined benefit plan has a 401(h) account and the assets of the 401(h) account are commingled in a master trust, are the required master trust disclosures included in the defined benefit plan or the health and welfare plan?
- A. Since the 401(h) assets legally belong to the defined benefit plan, the master trust disclosures should be included in the defined benefit plan's financial statements.

APPENDIX C

Claims Testing

There are three sources that the auditor may need to consult when testing claims. They are the sources that contain CPT codes, HCPCS codes, and ICD-9 codes.

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

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

The International Classification of Diseases, Ninth Edition, Clinical Modifications (ICD-9-CM) is published by the United States government and is the classification employed for cause-of-death coding. The ICD-9 coding system is recommended for use in all clinical settings and is required for reporting diagnoses and diseases to the U.S. Public Health Service.

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

APPENDIX D

Payroll Auditing

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), states that the auditor should assume that revenue recognition is an area where fraud could occur in any entity. For employee benefit plans the primary sources of revenue are income from investments and employer contributions. The AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (EBP Guide), contains chapters detailing audit procedures for investments and employer contributions.

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

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

What Is a Payroll Audit?

A payroll or compliance audit is an audit of a contributing employer to determine whether the employer has contributed the amount specified by the CBA to a multiemployer plan. Although they are called payroll audits, these examinations are actually agreed-upon procedure engagements. When a plan uses a CPA to perform payroll audits, the plan trustees will agree with the auditor about the records to examine and the steps to perform. The

CPA will perform the agreed-upon procedures specified and will write a report addressed to the trustees of the multiemployer plan detailing the findings of the engagement. Exhibit 2 of Chapter 4 of the nonauthoritative Practice Aid entitled *Auditing Multiemployer Plans* (the Multiemployer Practice Aid) shows an engagement letter that details the typical procedures performed in a payroll audit. Exhibit 4 in the same chapter of the Multiemployer Practice Aid provides an example of an agreed-upon procedures letter issued at the conclusion of a payroll audit. The agreed-upon procedures report issued will typically be in accordance with Statements on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT secs. 101-701), as amended.

Purpose of a Payroll Audit

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

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

Who Should Perform the Payroll Audits?

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

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

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

Are Payroll Audits Required?

Paragraph 10.08 of the EBP Guide states that in a multiemployer environment “plan sponsors or trustees may engage the employer’s auditor, other outsider auditors, in-house compliance personnel, or others to perform agreed upon procedures to test the completeness of employer contributions.” The Department of Labor has suggested that it is difficult to ensure the completeness objective over employer contributions without performing payroll audits and that without an effective payroll audit program, the plan auditor should consider issuing a qualified opinion on the plan’s financial statements.

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

How Often Should Payroll Audits Be Performed?

Paragraph 10.08 of the EBP Guide states that “a representative group of contributing employers should be tested each year.” Does this mean that every contributing employer will be audited within a three- or four-year cycle? While a three- or four-year cycle might be acceptable in a small plan, a national plan with thousands of contributing employers may never audit all contributing employers.

The plan should monitor from year to year the effectiveness of its payroll auditing program. The payroll audit program should help

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

APPENDIX E

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

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

1. Important Reminder for Fringe Benefit Plans

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

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

Fringe benefit plans are often associated with ERISA group health plans and other welfare benefit plans. The IRS announcement regarding fringe benefit plans does not cover these associated welfare plans. But, in many cases, a Form 5500 was not required for the welfare plan because it was exempt from filing a

Form 5500 report under Department of Labor regulations. For example, fully insured or unfunded welfare plans covering fewer than 100 participants at the beginning of the plan year are eligible for a filing exemption. Unless exempt, however, ERISA welfare plans must still file in accordance with the Form 5500 instructions on welfare plan filing requirements.

See IRS News Release No. IR 2003-89 and the Form 5500 instructions for more information.

2. The Form 5500 Must Be Properly Signed and Dated

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

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

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

3. The Form 5500 Must Have the Proper EIN and Plan Number (PN)

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

Schedule P which reports the EIN of the plan's employee benefit trust(s) or custodial account(s)).

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

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

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

Filers should consult the Form 5500 filing instructions for line 1b and 2b in Section 6, "Line-by Line Instructions", for additional information on EINs and PNs. The instructions for line 2b include information on how to obtain EINs from the IRS.

4. The Form 5500 Filing May Not Be for a Period Greater Than 12 Months

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

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

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

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

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

The only business codes that are valid for use in answering line 2d are listed in the Form 5500 filing instructions section marked "Codes for Principal Business Activity." If more than one employer and/or employee organization is involved, the business

code for the main business activity of the employers and/or employee organizations should be entered.

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

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

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

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

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

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

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

provides benefits. The “Benefit Arrangement” is the method by which the plan provides benefits to participants.

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

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

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

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

9. The Schedules Attached to Your Filing Must Match What You Report on Line 10 of the Form 5500

The information entered in the checklist on line 10 of the Form 5500 must match schedules that are submitted with the Form 5500. If a box is checked indicating that a schedule is attached, the schedule must be submitted with the Form 5500.

When filing Schedules A, P, or T, special care should be taken to enter the total number of each schedule filed in the spaces provided on line 10.

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

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

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

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

When filing Schedule H or I, filers should make certain that all required information provided is accurate and complete. Make sure the spaces on the asset/liability and income/expense statements (lines 1 and 2) on the Schedule H and I that require a total from the lines above are completed accurately.

Schedule H

If Schedule H is filed, Part III of the schedule, regarding the independent qualified public accountant's (IQPA) report and opinion, must be completed. The report of the IQPA identified on line 3 must be attached to the Form 5500 unless line 3d(1) or 3d(2), (3b(1) or 3b(2) on 2002 and prior year forms) is checked.

Plans filing Schedule H must answer all items in Part IV, lines 4a through 4k and line 5a. Check either "yes" or "no" as appropriate, and, where applicable, enter the dollar amounts or other information that is required. Not responding or indicating "n/a" to an item may cause the filing to be rejected.

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

Schedule I

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

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

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

11. Do Not Submit Loose Schedules or Attachments

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

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

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

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

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

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

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

Frequently Asked Questions on the Small Pension Plan Audit Waiver Regulation

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

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

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

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

2. Eligible Pension Plans

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

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

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

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

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

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

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

No. Small pension plans that cannot claim the audit waiver may still file Schedule I, but must attach the report of an IQPA to their Form 5500. They also do not need to include schedules of assets held for investment, a schedule of reportable transactions, the Schedule C, or Schedule G.

2e. If a small plan elects to file as a large plan pursuant to the 80-120 Participant Rule, can it still claim the small pension plan audit waiver?

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

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

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

3. General Conditions for Audit Waiver

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

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

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

Second, the plan must include certain information (described below) in the summary annual report (SAR) furnished to participants and beneficiaries in addition to the information ordinarily required.

Third, in response to a request from any participant or beneficiary, the plan administrator must furnish without charge copies of statements the plan receives from the regulated financial institutions holding or issuing the plan’s “qualifying plan assets” and evidence of any required fidelity bond.

3b. What are qualifying plan assets?

“Qualifying plan assets” are:

Any asset held by certain regulated financial institutions (see the next question);

Shares issued by an investment company registered under the Investment Company Act of 1940 (for example mutual fund shares);

Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state;

In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution describing the plan assets held or issued by the institution and the amount of such assets;

Qualifying employer securities, as defined in ERISA section 407(d)(5); and

Participant loans meeting the requirements of ERISA section 408(b)(1), whether or not they have been deemed distributed.

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

Only the following institutions are “regulated financial institutions” for purposes of the audit waiver conditions:

Banks or similar financial institutions, including trust companies, savings and loan associations, domestic building and loan associations, and credit unions;

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

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

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

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

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

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

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

Administrators can use the decision tree found in Exhibit 5-4 of the EBP Guide for guidance.

4. Qualifying Plan Assets

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

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

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

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

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

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

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

Generally, the account must be a trust or custodial account. For example, plan assets held in bank custodial, common or collective trust, or separate trust accounts are qualifying plan assets. In addition, securities held by a broker-dealer for the plan in an omnibus account are qualifying plan assets. Checking and savings accounts that create a debtor-creditor relationship between the plan and the bank are also “qualifying plan assets” for purposes of the audit waiver conditions.

4e. If I put plan assets in a bank safe deposit box, can I treat those assets as “qualifying plan assets”?

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

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

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

5. Fidelity Bonding For Nonqualifying Assets

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

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

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

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

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

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

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

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

For example, a person may handle a total of \$1 million in plan funds, but only \$50,000 are nonqualifying plan assets. In that case, the ERISA section 412 bond covering the person should be

equal to or greater than \$100,000, which would be more than the value of the nonqualifying assets the person handles. For that person, the ERISA section 412 bond would also satisfy the audit waiver enhanced bonding requirement.

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

6. Summary Annual Report (SAR) Disclosures

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

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

Except as noted in the following question below, the name of each regulated financial institution holding or issuing “qualifying plan assets” and the amount of such assets reported by the institution as of the end of the plan year;

The name(s) of the surety company issuing enhanced fidelity bonding, if the plan has more than 5 percent of its assets in “non-qualifying plan assets”;

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

A disclosure stating that participants and beneficiaries should contact the DOL’s Employee Benefits Security Administration (EBSA) regional office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond.

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

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

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

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

In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control provided the participant or beneficiary is furnished, at least annually, a statement from an eligible regulated financial institution describing the assets held or issued by the institution and the amount of such assets.

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

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

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

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

The following is model language for a notice:

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

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

[set forth amounts and names of institutions as applicable]

[insert \$ amount] in assets held by [insert name of bank],

[insert \$ amount] in securities held by [insert name of registered broker-dealer],

[insert \$ amount] in shares issued by [insert name of registered investment company],

[insert \$ amount] in investment or annuity contract issued by [insert name of insurance company]

The plan receives year-end statements from these regulated financial institutions that confirm the above information. [Insert as applicable:] The remainder of the plan's assets were (1) qualifying employer securities, (2) loans to participants, (3) held in individual participant accounts with investments directed by participants and beneficiaries and with account statements from regulated financial institutions furnished to the participant or beneficiary at least annually, or (4) other assets covered by a fidelity bond at least equal to the value of the assets and issued by an approved surety company.

Plan participants and beneficiaries have a right, on request and free of charge, to get copies of the financial institution year-end statements and evidence of the fidelity bond. If you want to examine or get copies of the financial institution year-end statements or evidence of the fidelity bond, please contact [insert mailing address and any other available way to request copies such as e-mail and phone number].

If you are unable to obtain or examine copies of the regulated financial institution statements or evidence of the fidelity

bond, you may contact the regional office of the U.S. Department of Labor's Employee Benefits Security Administration (EBSA) for assistance by calling toll-free 1.866.444.EBSA (3272). A listing of EBSA regional offices can be found at www.dol.gov/ebsa. General information regarding the audit waiver conditions applicable to the plan can be found on the U.S. Department of Labor Web site at www.dol.gov/ebsa under the heading "Frequently Asked Questions."

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