Companion to PPC’s Guide to

Audits of Employee Benefit Plans
Interactive Self-study CPE

Companion to PPC’s Guide to Audits of Employee Benefit Plans

TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>COURSE 1: PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>7</td>
</tr>
<tr>
<td>Lesson 1: Pre-engagement and Audit Planning Activities</td>
<td>9</td>
</tr>
<tr>
<td>Lesson 2: Understanding the Plan and Its Environment, Including Internal Control</td>
<td>53</td>
</tr>
<tr>
<td>Lesson 3: Audit Planning Decisions and Judgments, Audit Sampling, Audit Plans and Workpapers, and Special Planning Considerations in Initial Engagements</td>
<td>99</td>
</tr>
<tr>
<td>Glossary</td>
<td>141</td>
</tr>
<tr>
<td>Index</td>
<td>143</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COURSE 2: SPECIAL AUDITING CONSIDERATIONS</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>145</td>
</tr>
<tr>
<td>Lesson 1: Employer Contributions Received and Receivable, Audit of Investments, Contracts with Insurance Companies, and Participant Data</td>
<td>147</td>
</tr>
<tr>
<td>Lesson 2: Benefit Payments, Benefit Obligations, Other Assets, Liabilities, and Operating Expenses, and Change in Service Organizations</td>
<td>209</td>
</tr>
<tr>
<td>Glossary</td>
<td>243</td>
</tr>
<tr>
<td>Index</td>
<td>245</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COURSE 3: CONCLUDING THE AUDIT</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
<td>247</td>
</tr>
<tr>
<td>Lesson 1: The Effect of Commitments on the Conclusion of the Audit</td>
<td>249</td>
</tr>
<tr>
<td>Lesson 2: The Use of the Management Representation Letter, Workpapers and Risk Assessment on Concluding the Audit</td>
<td>281</td>
</tr>
<tr>
<td>Lesson 3: The Preparation of Financial Statements and the Required Communication from the Auditor</td>
<td>315</td>
</tr>
<tr>
<td>Glossary</td>
<td>359</td>
</tr>
<tr>
<td>Index</td>
<td>363</td>
</tr>
</tbody>
</table>
To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

Course 1: Testing Instructions for Examination for CPE Credit .................................................. 365
Course 1: Examination for CPE Credit Answer Sheet ................................................................. 367
Course 1: Self-study Course Evaluation ......................................................................................... 368
Course 2: Testing Instructions for Examination for CPE Credit .................................................. 369
Course 2: Examination for CPE Credit Answer Sheet ................................................................. 371
Course 2: Self-study Course Evaluation ......................................................................................... 372
Course 3: Testing Instructions for Examination for CPE Credit .................................................. 373
Course 3: Examination for CPE Credit Answer Sheet ................................................................. 375
Course 3: Self-study Course Evaluation ......................................................................................... 376
INTRODUCTION

Companion to PPC’s Guide to Audits of Employee Benefit Plans consists of three interactive self-study CPE courses. These are companion courses to PPC’s Companion to PPC’s Guide to Audits of Employee Benefit Plans designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at OnlineGrading.Thomson.com or by mailing or faxing your completed Examination for CPE Credit Answer Sheet for print grading by February 28, 2011. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of employee benefit plans. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, answer the examination questions which follow each lesson. You may either record your answer choices on the printed Examination for CPE Credit Answer Sheet or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the Statement on Standards of Continuing Professional Education (CPE) Programs (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the “Overview” page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.
You may fax your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate Examination for CPE Credit Answer Sheet. Payment of $79 must accompany each answer sheet submitted. We would also appreciate a separate Course Evaluation from each person who completes an examination.

Express Grading. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

Retaining CPE Records

For all scores of 70% or higher, you will receive a Certificate of Completion. You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 431-9025 for more information.
COMpanion To PPC’S GUIDE TO AUDITS OF EMPLOYEE BENEFIT PLANS

COURSE 1

PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING (EBPTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses the activities that should take place when deciding whether to propose for or accept a benefit plan client or to retain an existing client. It also discusses the necessary activities in the early planning stages of a new or continuing audit engagement.

PUBLICATION/REVISION DATE: February 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Employee Benefit Plans

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by February 28, 2011

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Pre-engagement and Audit Planning Activities

Completion of this lesson will enable you to:
- Identify pre-engagement activities and preliminary planning activities, and employee benefit plan acceptance and retention considerations.
- Describe an overall audit strategy for the expected conduct, organization, and staffing of the audit.

Lesson 2—Understanding the Plan and Its Environment, Including Internal Control

Completion of this lesson will enable you to:
- Recognize the types of employee benefit plans that may be encountered in practice.
- Identify the components of internal control and their impact.

Lesson 3—Audit Planning Decisions and Judgments, Audit Sampling, Audit Plans and Workpapers, and Special Planning Considerations in Initial Engagements

Completion of this lesson will enable you to:
- Identify audit planning considerations for employee benefit plans as well as timing and coordination considerations.
- Describe audit sampling, detailed audit plans and workpapers, and special planning considerations.
TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters  
Tax & Accounting—R&G  
EBPTG101 Self-study CPE  
36786 Treasury Center  
Chicago, IL  60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: Pre-engagement and Audit Planning Activities

INTRODUCTION

This course discusses the activities that should take place when deciding whether to propose for or accept a benefit plan client or to retain an existing client. It also discusses the necessary activities in the early planning stages of a new or continuing audit engagement. Under ERISA, employee benefit plans generally do not have to file audited financial statements until they have 100 or more participants.

Pre-engagement activities involve consideration of the auditor’s ability and desire to propose for, accept, or retain a particular benefit plan engagement, including the auditor’s independence, technical expertise, and ability to meet ERISA audit requirements; the plan management’s integrity; and the scope of the audit. Pre-engagement activities also include communicating with the predecessor auditor, if there is one, and establishing the terms of the engagement.

Planning activities include obtaining an understanding of the plan and its environment, including ERISA, tax, and DOL laws and regulations, and the particular plan’s provisions, activities, internal control, and factors, including fraud, that affect the risk of material misstatements in its financial statements. These activities allow the auditor to make a decision about the acceptance or continuance of a client relationship, but certain pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify pre-engagement activities and preliminary planning activities, and employee benefit plan acceptance and retention considerations.
- Describe an overall audit strategy for the expected conduct, organization, and staffing of the audit.

Authoritative Literature

Pre-engagement Activities. The authoritative pronouncements that establish requirements or provide guidance that most directly affects pre-engagement activities are as follows:

a. SAS No. 84 (AU 315), *Communications Between Predecessor and Successor Auditors*, establishes the required communications that should occur prior to client acceptance when a change of auditors has taken place.

b. SAS No. 108 (AU 311), *Planning and Supervision*, provides requirements relating to client acceptance and continuance and establishing an understanding with the client, including the issuance of a written engagement letter.

c. SQCS No. 7 (QC 10), *A Firm’s System of Quality Control*, describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm’s quality control system should encompass.

d. Interpretation 101-3 (ET 101.05), *Performance of Nonattest Services*, of the AICPA’s *Code of Professional Conduct*, provides guidance regarding an auditor’s independence in relationship to an attest client when performing nonattest services.

In addition to the items listed, auditors need to comply with other ethical requirements of the AICPA’s *Code of Professional Conduct* when considering whether an engagement can be accepted or continued. These authoritative pronouncements are explained further at the relevant points in the following discussion.
Preliminary Planning

The authoritative pronouncements that establish requirements and provide guidance that affect preliminary audit planning are as follows:

a. SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*, requires auditors to consider audit risk and determine and document materiality at both the financial statement and relevant assertion level, when planning the audit.

b. SAS No. 108 (AU 311), *Planning and Supervision*, addresses planning the audit, including topics such as establishing an overall audit strategy, developing the audit plan, involvement of professionals with specialized skills, supervision of assistants, communication with management and those charged with governance, and considerations in initial audits.

c. SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes the level of understanding of the plan and its environment, including its internal control, that the auditor should obtain for preliminary planning purposes. It also addresses risk assessment procedures and assessing the risks of material misstatement.

d. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, explains the factors that affect a decision to apply substantive procedures before the financial statement date and other aspects of designing further procedures.

In addition, aspects of the following standards also affect audit planning:

a. SAS No. 54 (AU 317), *Illegal Acts by Clients*, indicates that the auditor’s responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and fraud. For other illegal acts, the auditor, in conducting the audit, remains aware of their possibility, but does not design the audit specifically to detect them.

b. SAS No. 56 (AU 329), *Analytical Procedures*, requires the auditor to apply analytical procedures during the planning stage (and the overall review stage) of the audit.

c. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud and to design the audit to obtain reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

These authoritative pronouncements are also explained further at the relevant points in the following discussion.

In addition, the following authoritative literature is specifically or particularly relevant to employee benefit plan pre-engagement and planning activities:

a. SAS No. 73 (AU 336), *Using the Work of a Specialist*, applies when an auditor uses the work of a specialist in obtaining evidential matter about aspects of the financial statements. The SAS specifically identifies using the work of actuaries related to actuarial determinations and the work of appraisers related to valuing restricted securities. Both of these uses of specialists are common in audits of employee benefit plans.

b. SAS No. 70 (AU 324), *Service Organizations*, as amended, specifically applies when an employee benefit plan uses a bank trust department to invest and hold plan assets. The SAS gives guidance relevant to the plan auditor’s consideration of the effect of a service organization that executes and processes transactions for another entity (the plan) on the plan’s internal control in planning the audit and in auditing investments and insurance contracts in trustee arrangements. It also gives detailed guidance on the plan auditor’s considerations in deciding the need for, or desirability of, obtaining a service auditor’s SAS 70 report on the controls at the service organization and on the auditor’s use of the service auditor’s SAS 70 report.

c. AICPA Audit and Accounting Guide, *Employee Benefit Plans (AEBP)*, discusses aspects of auditing unique to employee benefit plans, including unique planning considerations. It applies to audits of defined benefit and defined contribution retirement plans and health and welfare benefit plans.
d. AICPA Code of Professional Conduct and related interpretations and rulings discuss the effect on auditor independence of various services to, and relationships with, employee benefit plans and plan sponsors.

These pronouncements are also discussed at relevant points in the course.

**ASB Project**

The Auditing Standards Board (ASB) is completing its large-scale project to redraft and revise all existing U.S. auditing standards to improve clarity and to converge with the International Standards on Auditing (ISAs). PPC’s Guide to Audits of Nonpublic Companies includes additional information regarding that project and provides a listing of the standards that have been finalized and the standards that are in exposure stage as of the date of that Guide. The ASB anticipates that the redrafted and clarified SASs, except those that address current issues, will be effective for audits of financial statements no earlier than for periods beginning on or after December 15, 2010. Standards that address current issues could have earlier effective dates.

**ENGAGEMENT ACCEPTANCE AND CONTINUANCE**

The auditor’s broad responsibilities under professional standards regarding client acceptance and continuance decisions are as follows:

- **Establishing Policies and Procedures.** SQCS No. 7 (QC 10) requires CPA firms to establish policies and procedures for deciding whether to accept or continue a client and whether to perform a specific engagement for that client. The requirement to establish such policies and procedures is not intended to suggest that a firm must guarantee the integrity or reliability of a client. Instead, the policies and procedures established should provide reasonable assurance that the risks associated with providing professional services in a particular circumstance are acceptable.

- **Timing of Procedures.** SAS No. 108 (AU 311) indicates that auditors should perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement. Before accepting an engagement, auditors should also determine whether circumstances will allow an adequate audit and an unqualified opinion, unless the plan requests a DOL limited-scope audit. If it appears that a qualified or disclaimer of opinion may be necessary, that should be discussed with the client.

- **Communicating with Previous Auditors.** SAS No. 84 (AU 315) and SAS No. 108 require a successor auditor to make certain inquiries of the predecessor auditor before accepting an engagement.

Client acceptance/continuance policies and procedures should provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.

- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Many auditors have traditionally viewed the client acceptance/continuance process as being limited to gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement, but the information gathered also generally affects later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and developing a detailed audit plan, as well as for other audit purposes. SAS No. 106 (AU 326.02) specifically notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, SQCS No. 7 requires that the firm document how the issues were resolved.
Risk-based Perspective

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement should be declined and when the relationship with a continuing client should be terminated. If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor’s own business risk) and also involves a greater risk of material misstatement of the financial statements. Both SAS No. 99 (AU 316.34) and SAS No. 109 (AU 314.13) explicitly note that the auditor should consider whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new employee benefit plan audit engagement, the auditor obtains a general understanding of plan management’s reputation and integrity and of the employee benefit plan industry, and the plan’s operations and financial condition through discussions with plan management, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor’s continuance decision.

The engagement acceptance or continuance decision normally focuses on factors that increase overall financial statement risk. What is the intended use of the financial statements? For example, to meet ERISA filing requirements. Do discussions with the predecessor auditor, bankers, insurance carriers, actuaries, attorneys, or others raise any concerns about plan management’s integrity? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate employee benefit plan and overall audit experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee estimates) will be affected by any risks that have been identified through client acceptance or continuance; thus, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable. Many of these matters are audit strategy issues.

Before deciding to propose for or accept a new employee benefit plan audit engagement, the auditor should consider his or her ability to accept the engagement, plan management’s integrity, and the scope of the proposed audit. These considerations should also be made annually in deciding whether to retain an existing client.

Ability to Accept the Engagement

An auditor should not propose for, or accept, an audit unless he or she will be able to meet the responsibilities and requirements related to the engagement. Factors to be considered include the following:

- Auditor independence.
- Expertise in the employee benefit plan area or ability to obtain sufficient knowledge to meet professional standards.
- Ability to meet the engagement’s time requirements and deadlines.
- Ability to meet ERISA audit requirements.

These matters are discussed in the following paragraphs.

Independence

The AICPA, state boards, the Securities and Exchange Commission, the PCAOB, and the Department of Labor each have their own independence rules. Some of the AICPA independence rules apply a team approach, which
narrowed the pool of those members of a firm who are subject to certain independence requirements by focusing on covered members. Covered members are those who are members of an attest engagement team or able to influence the engagement or attest engagement team. Under the AICPA rules, auditors may be able to structure the engagement team so that independence is not impaired. Auditors contemplating a benefit plan engagement might be members of the plan’s administrative committee or of the plan itself. They might audit the plan sponsor or provide the plan or sponsor with appraisal, actuarial, or accounting services, or other services. Thus, the auditor should consider whether such memberships or activities impair independence with respect to the potential client. Some specific considerations in applying independence rules in small employee benefit plan engagements are discussed in the remaining paragraphs of this section.

Nonattest Services. For many small employee benefit plan engagements, a frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services, actuarial services, or preparing the Form 5500 for the plan. An auditor may be asked to provide these services to clients who are too small to employ an adequate accounting staff. Concerns may arise that an auditor’s independence has been impaired in these circumstances.

According to Interpretation 101-3, Performance of Nonattest Services, of the AICPA’s Code of Professional Conduct (ET 101.05), before auditors perform nonattest services, they should determine that the requirements of Interpretation 101-3 have been met. Interpretation 101-3 requires the following with respect to the performance of nonattest services:

- The auditor should not perform management functions or make management decisions for the attest client.
- The client must agree to perform certain specific functions in connection with the nonattest services.
- The auditor should document in writing the understanding with the client regarding the nonattest services and the client’s responsibilities.

Under the Interpretation, independence is considered to be impaired if an auditor (or his or her firm) performs management functions or makes management decisions for an attest client. However, the auditor may assist management in those functions or decisions. For the auditor to remain independent, the client must agree to perform all of the following functions in connection with the engagement to perform nonattest services:

- Make all management decisions and perform all management functions.
- Designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee the services.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

The auditor should also be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the nonattest services. If the client is unable or unwilling to assume its responsibilities, performance of the nonattest services would impair independence.

The Interpretation also requires the auditor to document in writing his or her understanding with the client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client’s acceptance of its responsibilities.
- Auditor’s responsibilities.
- Any limitations of the engagement.
The Interpretation does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. It is considered common in many employee benefit plan audit engagements for auditors to also provide nonattest services, such as preparation of the Form 5500, actuarial services, or bookkeeping services.

Certain activities performed as part of a nonattest service are considered to be management functions and, therefore, impair independence regardless of whether the auditor complies with the other requirements of Interpretation 101-3. The Interpretation lists common nonattest service activities and notes whether they are considered to impair independence. The Interpretation specifically states that performance of the following activities relevant to audits of employee benefit plans would impair an auditor’s independence:

- Having custody of plan assets.
- Serving as a fiduciary, as defined by ERISA.
- Making disbursements on behalf of a plan.
- Making policy decisions on behalf of plan management.
- When dealing with plan participants, interpreting the plan document on behalf of plan management without first obtaining the concurrence of plan management.
- Establishing or maintaining internal controls, including performing ongoing monitoring activities for a client.

In addition, under Interpretation 101-3, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or a valuation related to an employee stock ownership plan, generally involves significant subjectivity, and, therefore, would impair independence if performed for financial statement purposes. On the other hand, an actuarial valuation of a client’s pension or postemployment benefit liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

The Interpretation recognizes that various other regulatory bodies (e.g., the SEC or the DOL) may have independence rules related to nonattest services that are more stringent than those contained in Interpretation 101-3. The Interpretation states that the failure to comply with the independence requirements of such regulatory bodies constitutes a violation of the Interpretation. Thus, auditors of employee benefit plans should be aware of the independence regulations promulgated by the DOL.

Should Proposing Journal Entries and Preparing Financial Statements in Connection with an Audit Be Viewed as Bookkeeping and, Therefore, Nonattest Services? Interpretation 101-3 includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, the Interpretation provides several examples of services that would be considered bookkeeping. Two of those examples are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client and (b) preparing financial statements based on information in the trial balance. Practice questions have arisen as to whether those examples mean that proposing journal entries and preparing financial statements in connection with an audit should be viewed as bookkeeping and, therefore, nonattest services subject to the Interpretation. As a practical matter, small and midsize employee benefit plans typically view proposing journal entries and preparing financial statements as part of the audit, and, based on implementation guidance provided in questions and answers published by the AICPA Professional Ethics Executive Committee (PEEC) during 2004 and 2005, it is thought to be clear that PEEC did not intend for Interpretation 101-3 to require viewing those services as separate from the audit.

Bookkeeping services are viewed as services that involve processing an entity’s transactions or preparing an entity’s accounting records. Bookkeeping services that—

a. Constitute management functions, such as authorizing or approving benefit payments would impair independence.
b. Do not constitute management functions, such as recording benefit payments approved by management or initiated by plan participants, would not impair independence provided the auditor obtained the understanding with the entity required by the Interpretation. Failure to obtain the required understanding would impair independence. However, failure to comply with the Interpretation’s requirement to document that understanding would not impair independence but would be a violation of Rule 202, Compliance With Standards, of the AICPA’s Code of Professional Conduct.

It is believed that performing procedures in connection with an audit are designed to address audit risk arising from the lack of control activities, such as reconciling carrying amounts of assets and liabilities with amounts reported by third parties (such as trustees or custodians), would not be considered bookkeeping services. Similarly, preparing financial statements as part of an audit would not be considered a bookkeeping service. Neither of those services involves processing the entity’s transactions or preparing its accounting records. Proposing adjustments of an entity’s accounting records in connection with an audit also would not be considered a bookkeeping service. Those are adjustments of the accounting records prepared by the entity. Accordingly, they would not be viewed as bookkeeping services and, therefore, would not be viewed as subject to the Interpretation.

Because the entity is required to accept responsibility for the fair presentation in the financial statements of the net assets available for benefits (or “financial status” if the plan is a defined benefit retirement plan or a defined benefit health and welfare plan) and changes in net assets available for benefits (or “financial status”) of the plan in conformity with generally accepted accounting principles, the authors believe the number of journal entries proposed in connection with an audit is not relevant to whether that is a bookkeeping service and, therefore, subject to the Interpretation. As a practical matter, however, the entity’s accounting records may be in such poor condition that the auditor cannot perform sufficient procedures to determine the journal entries needed to express an unqualified opinion. To overcome the scope limitation, bookkeeping services may be performed to bring those inadequate accounting records into substantial completion so that the auditor can perform the required procedures.

Auditors who are unable to make a judgment as to whether they are providing bookkeeping services are not prohibited from concluding that they are providing services subject to the Interpretation and following the Interpretation’s requirements. The AICPA has an Ethics Hotline where members of the AICPA’s Professional Ethics Team answer questions about independence and other behavioral issues. The toll-free number for the Ethics Hotline is (888) 777-7077.

The following additional interpretations and rulings provide further guidance on auditor independence in various situations related to employee benefit plans, trusts, and plan sponsors:

a. Interpretation 101-1 (ET 101.02) of the AICPA Code of Professional Conduct, entitled Interpretation of Rule 101, states that independence is impaired if “during the period of the professional engagement a covered member had or was committed to acquire any direct or material indirect financial interest in the client.”

The Interpretation also states that independence is impaired if “during the period covered by the financial statements or during the period of the professional engagement, a firm, or partner or professional employee of the firm was simultaneously associated with the client as a(n) director, officer, or employee, or in any capacity equivalent to that of a member of management, . . . promoter, underwriter, or voting trustee, . . . or trustee for any pension or profit-sharing trust . . . .” Thus, for example, a CPA could not audit a plan for which his or her firm acted as a professional third-party plan administrator (TPA).

b. Ethics Ruling No. 19 (ET 191.037–.038), Member on Deferred Compensation Committee, states that membership by any partner or professional employee of the firm on a committee that administers a deferred compensation program impairs independence because such membership would be participation in management functions. It is believed that by analogy, an auditor’s membership on an employee benefit plan’s administrative committee would also impair his or her (and his or her firm’s) independence with respect to the plan. The ruling notes that consulting services could be rendered without joining the committee.

c. Ethics Ruling No. 21 (ET 191.041–.042), Member as Director and Auditor of an Entity’s Profit Sharing and Retirement Trust, states that any partner or professional of the firm serving as director of an entity impair
independence with respect to the entity’s profit-sharing and retirement trust. The reason is that being a
director of the enterprise involves management functions that affect the plan. It is believed this means that
being a director of a plan sponsor would also impair independence of the sponsor’s employee benefit plan.

d. Ethics Ruling No. 60 (ET 191.119–120), Employee Benefit Plans—Member’s Relationships with
Participating Employer, states that the auditor’s independence would be considered impaired if “any
partner or professional employee of the firm had significant influence over such employer, was in a key
position with the employer, or was associated with the employer as a promoter, underwriter or voting
trustee.” This guidance is less restrictive than the DOL regulations. If the plan is subject to ERISA, the auditor
must comply with the DOL independence regulations.

e. Ethics Ruling No. 107 (ET 191.214–215), Participation in Health and Welfare Plan Sponsored by Client,
states that a covered member would not be considered independent of a plan or the plan sponsor if the
covered member participates in a plan sponsored by a client. However, if the covered member participates
in or receives benefits from a plan solely because of the permitted employment of the covered member’s
immediate family, the covered member would be considered independent to the plan as long as employees
in equivalent positions with the plan sponsor also have the opportunity to participate in the plan.

f. Ethics Ruling No. 111 (ET 191.222–223), Employee Benefit Plan Sponsored by Client, states that a firm
providing investment management or custodial services for an employee benefit plan would not be
independent of the plan. The ruling also states that if those services are provided to a defined benefit plan
for assets that are material to the plan or the sponsor, the member and member’s firm would also not be
independent of the plan sponsor. If those services are provided to a defined contribution plan, the member
and his firm would be considered independent of the plan sponsor as long as they did not make any
management decisions or perform management functions for the plan sponsor, or have custody of the plan
sponsor’s assets.

**Independence—ERISA and DOL Rules.** ERISA requires accountants engaged under its audit requirements to be
independent. The DOL has issued an interpretive bulletin (DOL Reg. 2509.759-9) concerning auditor independence
for ERISA audits. The regulations state that an auditor is not independent if during the engagement period, the
period covered by the financial statements, or at the date of the auditor’s report, the auditor, his firm, or any member
of the firm:

- Had, or was committed to acquire, a direct or material indirect financial interest in the plan or plan sponsor.
  This regulation differs in part from AICPA Ethics Ruling No. 60 (ET 191.119–120). The AICPA Ruling allows
  a direct or indirect financial interest in a plan sponsor or employers participating in a multiemployer plan
  if the auditor may not exert significant influence over the plan sponsor, whereas the DOL prohibits any direct
  or material indirect financial interest.

- Was a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee of the plan
  or plan sponsor. This is consistent with the AICPA Ethics Interpretation 101-1.

The DOL regulations also state that an accountant is not independent if he or any member of his firm “maintains
financial records for the employee benefit plan.” The meaning of “maintains financial records” is unclear, and, as
discussed in the following paragraphs, the AICPA and DOL differ about its meaning.

The AICPA independence rules allow auditors to provide certain bookkeeping services and remain independent.
Bookkeeping services, if provided in accordance with Interpretation 101-3, are not considered by the AICPA as
“maintenance of financial records.” Some DOL officials, however, disagree and more narrowly interpret “mainte-
nance of financial records.” The DOL has not issued any definition of what is meant by “financial records,” however,
some officials maintain that posting the general ledger from client-prepared underlying records and preparing
participant account balances for a defined contribution plan impairs independence. It is noteworthy that the DOL
patterned its interpretive bulletin after the SEC’s independence rules for auditors of public company financial
statements and that the SEC rules prohibit the auditor from providing all bookkeeping services, including posting
the general ledger and subsidiary ledgers from client-prepared underlying records.

The DOL position on independence poses a serious problem for plan auditors because many small plans,
particularly 401(k) plans, rely on their auditors for bookkeeping services or for maintaining individual participant
account balances. DOL officials have publicly stated that they take the DOL position very seriously and are reluctant to change it. In instances when the DOL concludes that the auditor is not independent, the audit report will likely be rejected and a civil penalty may be imposed against the plan administrator. The auditor may also be referred to the AICPA’s ethics division. Although the DOL requirements relating to bookkeeping services appear to be more stringent than the AICPA’s, auditors are required to comply with the more stringent requirements. AICPA Ethics Interpretation 101-3 states that failure to comply with the independence rules of an applicable regulatory body, such as the DOL, that are more restrictive than the Interpretation are considered a violation of the AICPA’s requirements.

The DOL regulations do allow the plan auditor to also audit the plan sponsor and remain independent. They also allow an accountant, or his or her firm, to provide actuarial services to the plan and remain independent. This provision is similar to a provision in AICPA Ethics Interpretation 101-3. However, the DOL rules do not mention whether providing appraisal or valuation services (for example, valuing real estate or securities that do not have a market price) would impair independence. DOL officials have publicly expressed concern about plan auditors also providing appraisal and valuation services to benefit plans. AICPA Ethics Interpretation 101-3 indicates that valuations related to an employee stock ownership plan or appraisals of assets or liabilities generally involve significant subjectivity and would, therefore, impair an auditor’s independence if material to the financial statements. A CPA providing recordkeeping, appraisal, or valuation services may need to seek a DOL interpretation about the effect on independence.

A client list should be routinely circulated to firm personnel to provide a basis for answering questions on independence matters.

The AICPA Quality Control Standards also address competence in performing audit engagements. SQCS No. 7 (QC 10.42) requires that a firm’s quality control policies and procedures provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities. The required competencies may vary depending on the client, industry, or type of service being provided. SQCS No. 7 (QC 10.44) specifically mentions employee benefit plan engagements when discussing certain industries that require different competencies than those expected in performing attest services for clients in other industries.

The auditor contemplating a benefit plan engagement should consider whether he or she has the necessary experience in the area or can obtain sufficient knowledge and understanding to perform the services requested through continuing education courses; study of ERISA, IRC, IRS and DOL documents and AICPA accounting and auditing guides; attendance at relevant conferences; discussions with knowledgeable persons; etc. The AICPA and most state licensing authorities have continuing education requirements for CPAs. In fulfilling these requirements, particular attention can be given to employee benefit plan accounting, auditing, and tax matters.

**Ability to Meet the Engagement’s Time Requirements and Deadlines.** The due date for filing IRS Form 5500 and the audited financial statements required to be filed with the Form 5500 is fairly lengthy, a minimum of seven months after the plan year end, and up to nine and one-half months after the plan year end if an extension is obtained. Nevertheless, the auditor of a plan subject to ERISA audit requirements must consider his or her ability to meet the deadline, especially since the plan administrator can be fined for a late filing. In evaluating his or her ability to meet the deadline, the auditor should consider not only the lengthy filing period, but also whether the plan year end differs from the December 31 year end that is common for business enterprises. These factors mean that the auditor may be able to perform a benefit plan audit in the auditor’s off-peak period and still meet the time deadline.

The auditor contemplating the audit of a defined benefit retirement plan should consider whether the plan has an end-of-year benefit information date, which requires an actuarial determination at year end rather than at the beginning of the plan year. Having to obtain an end-of-year actuarial determination could delay the audit’s completion date and limit the auditor’s flexibility in completing the audit. It could also create an audit time crunch if the actuarial determination is not completed well enough in advance of the filing due date. (However, use of a beginning-of-year benefit information date has implications for the financial statements and auditor’s report.)

**Ability to Meet ERISA Audit Requirements.** The auditor contemplating an audit of a plan subject to ERISA audit requirements should consider his ability to meet those requirements. For example, ERISA requires the auditor to report on schedules that accompany the financial statements. To report on them, the auditor must subject them to procedures applied in the audit of the financial statements and also determine that they contain the required information in the required format. The auditor’s failure to meet the ERISA and DOL audit and reporting require-
ments can subject the plan administrator to substantial fines. In addition, the Employee Benefits Security Administra-
tion (EBSA) has been actively reviewing workpapers and audit reports of benefit plan audits.

In evaluating ability to meet ERISA audit requirements, if the auditor is requested to perform a full-scope audit but
has only performed DOL limited-scope audits in the past, he or she should give due consideration to the difference
between the two types of audits and consider whether he or she would be able to perform a full-scope audit in a
cost effective manner.

Another consideration is that an ERISA audit will be subjected to a peer review. Members of the AICPA must
undergo peer reviews. The AICPA Peer Review Program requires at least one ERISA audit be included in the
engagements selected for peer review if the firm performs one or more ERISA audits.

Management Integrity

An auditor should always consider the reputation and integrity of a prospective or continuing client and its
management, but management integrity is especially significant for an employee benefit plan because of the
responsibilities ERISA imposes on plan administrators and other fiduciaries. Plan management, that is, the plan
administrator or administrative committee, is a fiduciary. ERISA requires fiduciaries, including management, to
perform their duties solely in the interest of plan participants, and with due care, prudence, and diligence according
to the plan documents and consistent with the provisions of ERISA. Fiduciaries also must not allow the plan to
engage in certain prohibited transactions with parties in interest. Prohibited transactions must be reported on
schedules accompanying the audited financial statements.

The auditor should evaluate any adverse information about the plan management and consider whether the CPA
firm would not want to be associated with the plan’s financial statements. The auditor’s concern is with the client’s
general honesty, good faith, and forthrightness in its plan operations, administration, and financial reporting and in
providing information, responses, and representations for the audit.

SQCS No. 7 (QC 10.27) requires CPA firms to establish policies and procedures “for the acceptance and continu-
ance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that
it will undertake or continue relationships and engagements only where the firm: (a) has considered the integrity of
the client . . . ; (b) is competent to perform the engagement and has the capabilities and resources to so do; and (c)
can comply with legal and ethical requirements.” There are no specific GAAS requirements concerning the depth
of an investigation of a prospective client, except the requirement in SAS No. 84 (AU 315), Communications
Between Predecessor and Successor Auditors, as amended, to communicate with a predecessor auditor. SAS No.
84, as amended, requires that a successor auditor communicate with any former auditors who have provided
services to the prospective client. The SAS requires written or oral communication with the predecessor auditor
when determining whether to accept an engagement. The communication should include the following matters:

a. Information that might bear on management’s integrity.

b. Disagreements with management on accounting principles, auditing procedures, or similarly significant
matters.

c. Communications to those charged with governance, such as the audit committee (or others with equivalent
authority and responsibility such as the board of directors or trustees) regarding fraud or other illegal acts
performed by the client or its employees, and internal control related matters.

d. The predecessor’s understanding of reasons for the change in auditors. The auditor can obtain
management’s explanation of the termination in Schedule C of Form 5500. The communication from the
predecessor gives his explanation.

In addition to communication with the predecessor auditor, the AICPA’s Guide for Establishing and Maintaining a
System of Quality Control for a CPA Firm’s Accounting and Auditing Practice suggests the following sources of
information (as they might apply to an employee benefit plan):

a. Review of available financial information about the prospective client, such as the plan’s most recent
financial statements and Form 5500.
Schedule C of Form 5500 (Service Provider Information), includes a section for the client to explain the reason for terminating an accountant or actuary. It explains any material disputes or disagreements concerning the termination, even if they were resolved before termination. Form 5500 requires the terminated party to be provided with a copy of the explanation and to be notified of the terminated party’s right to submit comments about the explanation to the DOL. Thus, review of Schedule C may provide information on matters related to management integrity.

b. Specific inquiry of the plan management about the nature and purpose of services to be provided.

c. Specific inquiry of the prospective client’s lawyer, banker, and others having business relationships with the plan.

Unless the client gives authorization, the predecessor cannot ethically respond to the successor’s inquiries because of the requirement for confidentiality in Rule 301 of the AICPA Code of Professional Conduct. If the potential client refuses to give authorization, the auditor should determine why. He should also consider whether such refusal is sufficient reason to decline the engagement because it may signal a lack of future cooperation and may deprive the auditor of useful information only the predecessor can provide.

Outsourcing

Ethics Ruling No. 112 (ET 191.224–225) under Rule 102, Integrity and Objectivity, requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider (that is, an entity not controlled by the audit firm or an individual not employed by the audit firm), to perform portions of the audit, the client must be informed before confidential information is shared with the service provider. If the client objects, the auditor should perform the services without using the third party or should decline the engagement. The ethics ruling applies when another party is used, for example, to audit an element, account, or item of the financial statements, or to act as a specialist. It is believed the ruling does not apply when another audit firm performs a separate engagement, the results of which will be used by the auditor, for example, when another firm audits the plan sponsor’s contribution. In addition, the client is not required to be informed when a third party is used only for administrative support services, such as record storage or software application hosting. Ethics Ruling No. 1 (ET 391.001–002) under ET Section 300, Responsibilities to Clients, requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. This rule also requires members to be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

Scope of the Audit

Information about the nature of the employee benefit plan and the scope of the audit being requested is vital in deciding whether to propose for the engagement, in preparing a proposal and reasonable fee estimate once a decision is made to do so, and in planning the audit once the engagement is obtained. Matters that affect the audit scope to be considered include the following:

- Whether the audit will be a DOL limited-scope audit.
- The nature of the plan.
- The type of trust arrangement.
- Whether the plan uses any third-party service organizations.
- The type of investments.
- The type of contracts with insurance companies, if any.
- The need to test participant data.
- The type of plan financial statements to be audited.
The type of auditor’s report to be issued on required supplemental schedules.

Whether the auditor will prepare Form 5500.

The need for an SEC filing.

Whether the audit is an initial audit.

These matters are discussed in the following paragraphs.

**DOL Limited-scope Audit.** DOL Regulation 2520.103-8 permits a limited-scope audit for plans with assets held by a bank, similar institution (for example, a regulated savings and loan association or credit union), or insurance company that is supervised and regulated and subject to periodic examination by a state or federal agency. AEBP, Paragraph 5.13, states that the DOL limited-scope audit does not apply to assets held by a broker, dealer, or an investment company. However, some brokers, dealers and investment companies have established separate trust companies to which, they assert, the limited-scope audit applies. DOL officials have publicly stated that the trust company must be established pursuant to state or federal laws that subject the trust company to regulation, supervision, and periodic examination by a state or federal agency for the limited-scope audit to apply. Also, the auditor should consider whether the institution qualifies for the DOL limited-scope audit if it is not apparent from the institution’s name that it qualifies, for example, by being a nationally recognized bank or insurance company.

The DOL has noted instances where DOL limited-scope audits were performed when the financial institution did not qualify. The auditor should note that the DOL limited-scope audit does not apply to third-party administrators or to service organizations such as claims processors, mortgage servicing agents, etc. In a DOL limited-scope audit, the auditor does not apply audit procedures to information on plan investment assets and related transactions that is prepared and certified to as both complete and accurate by the financial institution. AEBP, Paragraph 5.13, states that the DOL limited-scope audit does not apply unless the certification addresses both accuracy and completeness.) An example certification is included in DOL Regulation 2520.103-5(d)(2). (The certificate from the trustee should not be confused with confirming the investments with the trustee.)

In 2002, the EBSA issued a letter to clarify whether the auditor may rely on a certification letter signed by an agent of the trustee, rather than the trustee. For example, a recordkeeper that is an affiliate of a trustee that is a “qualified bank” based on ERISA guidelines, issues the letter certifying the completeness and accuracy of the plan’s investments. According to the EBSA, such a letter may be used if “the party providing the certification [is] in fact authorized to represent the insurance carrier, bank or similar institution holding the assets of the plan.” If there is a question as to whether the agent is authorized by the trustee to issue the letter, the plan administrator should first verify that such authority exists before authorizing the limited scope audit. The plan auditor may need to work with the plan administrator to obtain proper assurance that the agent is properly authorized by the trustee.

As discussed at DOL Reg. 2520.103-12, the plan administrator may also request the auditor to perform a limited-scope audit of the plan’s investment in a 10312 investment entity (10312 IE) if the 103–12 IE has properly filed its report with the DOL. Similar audit guidance applies as discussed in the previous paragraphs.

A DOL limited-scope audit usually involves less audit work and may be less costly than a full-scope audit. The auditor should note, however, that (as AEBP, Paragraph 5.13 states) the DOL limited-scope audit applies only to investment information and does not extend to participant data, contributions, benefit payments or other information, even if certified by the trustee or custodian. Audit work must still be performed on these areas. Thus, audit work would typically be required for areas such as contributions, benefit obligations, benefit payments, participant data, etc. In addition, the scope limitation does not extend to plan investments not certified by a qualified trustee or custodian. For example, real estate, mortgages, and participant loans may not be covered by a certification by a trustee or custodian. In such cases, the plan auditor is required to perform appropriate audit procedures on these assets as would be required in a full-scope audit. Furthermore, occasionally a qualified trustee or custodian may provide a certification for only a portion of the year under audit. This may occur in situations where a plan has changed trustees or custodians during the plan year. For the portion of the year not covered by that certification or a certification from another qualified trustee or custodian, the auditor would be required to perform full-scope audit procedures, unless that period is considered immaterial. Finally, all of the financial statement disclosures required
by GAAP and by DOL regulations and the supplemental schedules required by DOL continue to be required in a DOL limited-scope audit.

AEBP, Paragraph 7.66, notes that in a DOL limited-scope audit, the auditor’s responsibilities for the investments covered by the limited-scope exception include the following:

a. Reading the certification.

b. Considering whether the certifying entity is a qualifying institution under DOL regulations.

c. Comparing the certified investment information to the financial information in the plan’s financial statements and disclosures.

d. Performing procedures to determine that contributions received and benefit payments made, as reported by the trustee or custodian, comply with the provisions of the plan.

e. Assessing the form and content of the financial statement disclosures related to the certified investment information for conformity with GAAP and compliance with DOL rules and regulations.

When performing a DOL limited-scope audit, the auditor does not need to obtain an understanding of the certifying institution’s internal control over investments held and investment transactions executed on behalf of the plan. The auditor also is not required to assess control risk associated with those investments and related transactions executed by the certifying institution.

In addition, in a DOL limited-scope audit, the auditor is not responsible for testing the accuracy or completeness of the certified investment information. However, if the auditor believes the information received from the trustee or custodian is incomplete, inaccurate, or otherwise unsatisfactory, the auditor should further test the information. For example, if the plan has an investment in a nonactively traded REMIC that is held by a trustee, and the fair market value of the REMIC, as certified by the trustee, has not changed in three years, it would appear that the trustee has not obtained recent fair value information on the REMIC. In this case, the auditor should further test the information by having the plan administrator contact the trustee to request documentation for the fair value of the investment. If the information was not accurate, the plan administrator may request the auditor to perform a full-scope audit or ask the trustee for a revised certification. The auditor may need to modify the auditor’s report if unable to obtain appropriate information.

If the auditor becomes aware of errors or omissions in the supplemental schedules, or if required supplemental schedules are not presented with the financial statements, the auditor should consider modifying his or her report on the supplemental schedules.

If the information on plan investments provided by the trustee is not on the GAAP basis (for example, if it is on the cash basis, uses settlement date rather than trade date accounting, or reports investment gains and losses on the “revalued method” required for Form 5500), the auditor may have to make adjustments to the information to put it on the GAAP basis for inclusion in the financial statements and supplemental schedules. Consistent with AEBP, Paragraph 7.66, in a DOL limited-scope audit, it is not necessary to gain an understanding of, or test, control activities related to investment assets and related transactions for which information is certified by the bank, similar institution, or insurance company.

In spite of these qualifications, there is still a significant difference between a full-scope audit and a DOL limited-scope audit. Thus, if the option of a DOL limited-scope audit is available to the potential client, the auditor should determine if the audit being requested is to be so limited. The auditor should be sure that a client requesting a DOL limited-scope audit is aware such an audit usually results in a disclaimer of opinion on the financial statements and supplemental schedules because of the scope limitation.

**Nature of the Plan.** The type of employee benefit plan can have a significant impact on the audit procedures that may have to be applied. Thus, the nature of the plan should be included in the pre-engagement considerations. Examples of considerations related to the nature of the plan include the following:

- Auditing contributions and participant data for a multiemployer plan usually is more complex than for a single-employer plan and may entail additional audit procedures and special arrangements to examine
contribution records and participant data at the participating employers, or coordination with other auditors to perform these procedures.

- Auditing a defined benefit plan and some health and welfare plans necessitates communication with an actuary and consideration of actuarial determinations, while auditing a defined contribution plan generally does not entail such procedures.

- In the audit of a health and welfare benefit plan, procedures must be applied to uninsured benefit obligations whereas liabilities for benefit claims of an insured health and welfare plan are not included in the financial statements and thus need not be audited. (Note that a health and welfare benefit plan that is fully insured or is uninsured but unfunded is not required to be audited by ERISA.)

- More complex tax requirements, and thus tax considerations during the audit, may apply to a qualified plan than to a nonqualified plan.

The need to include the procedures mentioned above generally adds complexity, cost, and time to the audit and, thus, may influence the engagement acceptance decision or fee estimate.

**Type of Trust Arrangement.** The auditor should determine which type of trust arrangement, if any, the plan has, because it may affect the audit approach for plan investments.

In a full-scope audit, if the plan has a discretionary trust arrangement, under which the trustee has authority to initiate investment transactions, the auditor may need to obtain a service auditor’s SAS 70 report or a report on internal control from the trust institution’s auditor as a basis for accepting a confirmation from the trustee regarding the investments. If neither of these reports is available, it may be necessary to apply procedures at the institution’s trust department. Either approach involves audit coordination and cost that should be factored into the audit proposal.

If a service auditor’s SAS 70 or internal control report is not available and it is not possible or practical to apply audit procedures at the financial institution’s trust department, the auditor will usually determine that an unqualified auditor’s opinion on the financial statements cannot be issued. The potential for such a situation should be discussed as early as possible with the potential client since, any report other than an unqualified opinion generally does not meet the ERISA audit requirement.

Similar considerations apply to common or collective trusts if the trust does not have audited financial statements that the plan auditor can review in auditing the plan’s units of participation in the trust.

**Third-party Service Organizations.** The auditor should consider whether the plan uses any third-party service organizations, such as claims administrators for health and welfare benefit plans and, if so, whether the service organization has a valid service auditor’s SAS 70 report. Additional procedures may be necessary if a third-party service organization is involved (even if a DOL limited-scope audit is to be performed), and the extent of the procedures should be considered in preparing the audit proposal and fee estimate.

**Type of Investments.** The auditor should consider whether the plan’s investments are primarily marketable securities with active markets and readily available market quotations, or are restricted securities and other securities or investments that do not have a market price, such as real estate and mortgages. Valuation of such investments typically requires estimates by management that may be more difficult and costly to audit. The auditor should also consider the possibility that it may be necessary to use the services of a specialist to audit such valuations. The communication and planning necessary to use a specialist should be factored into the audit proposal and fee estimate.

Also, the auditor should consider the possibility that if securities are valued “in good faith” by management, there may be a significant uncertainty related to the valuation, or inadequate valuation procedures may have been used, that may require an auditor’s report modification. The potential for such a report modification should be identified as early as possible and discussed with management since such a report modification generally does not meet the ERISA audit requirement.
Types of Contracts with Insurance Companies. The auditor should determine whether the plan has any such contracts, and if so, whether they are allocated or unallocated contracts. Allocated contracts and plan benefits to be provided by such contracts are excluded from defined benefit plan financial statements. Unallocated contracts and related plan benefits are included, and therefore require audit attention to their measurement, valuation, and financial statement presentation.

Need to Test Participant Data. A normal audit procedure for all types of plans is to test participant payroll data and demographic information (hours worked, pay rates, earnings, hire and termination dates, age, sex, number of dependents, etc.). Such data is the basis for plan eligibility, benefit accruals for defined benefit plans, and contribution allocations for defined contribution plans. This data may be tested in auditing payroll in the audit of the plan sponsor’s financial statements. If it is, the plan auditor does not have to test it, and the audit scope and fee may be reduced. The plan auditor may or may not also audit the plan sponsor’s financial statements. If not, when considering audit scope for the proposed engagement, he or she should determine whether the other auditor has or will test participant data in auditing the plan sponsor’s statements.

Type of Financial Statements—OCBOA Statements. Under the alternative method of reporting prescribed by the DOL, the audited financial statements may be on the cash, modified cash, or accrual basis of accounting as long as plan assets are valued at current value. (AEBP, Paragraph 13.21), states that cash basis statements that adjust investments to fair value are considered to be modified cash basis statements.) Thus, it is possible that the financial statements to be audited will be on a basis of accounting other than GAAP (OCBOA), and the auditor should determine whether that will be the case.

If the statements will be OCBOA statements, the auditor should make sure the client understands that a SAS No. 62 (AU 623), Special Reports, report will be issued on such statements rather than the standard SAS No. 58 (AU 508) report appropriate for GAAP basis statements. The auditor may wish to review the wording of a SAS No. 62 OCBOA report with the client if the client is not familiar with it. The auditor should also make sure the client understands that OCBOA statements must include disclosures about benefit obligations, if applicable, or the SAS No. 62 report may have to be modified. Such a report modification generally does not meet the ERISA audit requirement.

Type of Financial Statements—Beginning-of-year Benefit Information Date. Defined benefit retirement plans have the option of presenting information about benefit obligations as of the beginning or end of the plan year. Use of a beginning-of-year benefit information date may enhance the auditor’s ability to meet the audit deadline.

Type of Financial Statements—Trust Fund. Although SFAS No. 35 (FASB ASC 960) and AEBP establish the employee benefit plan as the reporting entity, the auditor may be engaged to audit the financial statements of a plan’s trust fund. The scope of such an audit is likely to be significantly less extensive than the audit of the plan because the trust financial statements only include plan net assets and, for a defined benefit plan, do not include any plan benefit obligation information.

If requested to audit the trust instead of the plan, the auditor should determine whether the plan is required to have an audit under ERISA. Audited financial statements of the trust will not fulfill an ERISA requirement for audited plan financial statements, and the auditor should make sure the client understands this.

Type of Report on Required Supplemental Schedules. In an ERISA audit, the auditor must report on schedules that ERISA requires to accompany the audited financial statements. Usually, the auditor is engaged to report on the schedules under SAS No. 29 (AU 551), Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents. A SAS No. 29 report expresses an opinion on the schedules in relation to the basic financial statements taken as a whole. Expressing such an opinion only requires that the schedules be subjected to the procedures applied in auditing the financial statements, and the materiality level is the same as that used in the audit of the basic statements.

However, AEBP, Paragraph 5.18, points out that the auditor may be engaged to express an opinion on the information in the schedules in accordance with SAS No. 62 (AU 623), Special Reports. Expressing such an opinion requires materiality to be related to each individual element, item, or account reported on, which is normally a lower materiality level than for reporting under SAS No. 29. Thus, the auditor could expect to have to do more work to report on the schedules under SAS No. 62. Therefore, the type of report the client desires for the supplemental schedules should be determined when proposing for the engagement.
Preparation of Form 5500. In the pre-engagement discussions with the potential client, the auditor should establish who will prepare Form 5500 and related schedules as applicable. The plan administrator may request the auditor to prepare Form 5500. The additional time required to prepare the form can be extensive and should be considered in the proposed time schedule and fee estimate.

If the auditor will prepare Form 5500, he should keep in mind that preparation does not affect the auditor’s responsibility under GAAS. AEBP Paragraph 12.32, states that “the auditor’s responsibility for information in the Form 5500 does not extend beyond the financial information identified in his or her report, and the auditor has no obligation to perform any procedures to corroborate other information contained in the Form 5500.”

If the auditor will prepare Form 5500, he should be alert during the audit to accumulate information for the form or related schedules that is not needed strictly for audit purposes. It may be more efficient to accumulate information for the form during the audit while the auditor is examining client records for audit purposes. However, just because the auditor gathers information needed for the form during the audit, does not mean that the information must be audited if it is immaterial or not necessary for purely audit purposes. For example, the auditor would not necessarily have to audit immaterial payments to service providers, although the audit workpapers might include all payments of $5,000 or more for reporting on Schedule C of Form 5500.

Also, even if the auditor does not prepare Form 5500, the auditor must apply SAS No. 8 procedures to it, that is, read it and any related schedules for any material inconsistencies with the financial statements or any material misstatements of fact. The recommendation to do this before issuing the auditor’s report means that the form should be completed before the report is issued. The auditor should consider the effect of this recommendation when estimating the report delivery date and discuss it with the potential client if necessary.

Need for SEC Filing. Some plans involve an offer to sell securities or interests in the plan that are considered securities and must report to the SEC. If the potential client has not indicated the need for an SEC filing, but the auditor believes one may be required, he should discuss the matter with the potential client and possibly suggest that the client obtain legal advice on the matter. (This course does not cover SEC filings.) SEC registration statements and annual filings typically require specific expertise and additional work that the auditor would need to factor into his or her proposal and fee estimate. Also, the SEC requires a full-scope audit—a DOL limited-scope audit would not be acceptable. Finally, shorter filing deadlines may apply to such filings. Thus, if the potential engagement involves such a filing, the auditor should carefully consider his or her ability and desire to undertake the engagement.

Initial Audit. A consideration that will significantly affect the scope of a new audit client is whether the plan was previously audited by another auditor or has not previously been audited. Small plans, those with just over 100 participants, are less likely to have been audited because ERISA generally doesn’t require audits of plans with fewer than 100 participants. The DOL requirement to present a comparative statement of net assets available for benefits also applies at the time of the first audit. The prior year statements may, however, be compiled or reviewed if they were not audited. Whether or not the plan was audited in the previous year, in addition to auditing the current year’s ending balances and transactions during the year, the auditor will have to apply additional procedures to substantiate opening balances and to obtain assurance about the consistency of accounting principles between the current and preceding year. The proposing auditor should factor the cost of the extra work in the proposal and fee estimate.

If the first plan period is a short period of seven months or less, and an audit is otherwise required, the audit of the short period can be deferred until the second period (the first full year). In those instances, the initial audit report must address both the initial short period and the full second year. In other words, both the statement of net assets available for benefits and the statement of changes in net assets available for benefits must present the short period and the second full year in separate columns.

The extent of the auditor’s additional procedures in his or her initial audit of a plan usually is greater if the plan has never been audited than if it was audited in the preceding year. The reason is that if the plan was previously audited by another auditor, the successor can usually rely on the predecessor’s work as a source of evidence about opening balances of plan assets, liabilities, and benefit obligations, and about the accounting principles used in the preceding period. No such reliance is possible for a previously unaudited plan.
DOCUMENTING THE ENGAGEMENT ACCEPTANCE OR RETENTION DECISION

It is recommended that the auditor document the considerations discussed in the preceding section as they are made during the proposal, pre-engagement, or early planning stages. The documented information about independence, ability to provide the requested service, and management integrity will provide a basis for the auditor’s decision about whether to accept or retain the client. Other information on the type of plan, investments, trust arrangements, report on schedules, etc., will be useful in later stages of the audit and will serve as a basis for review and update in future years. When performing client acceptance (and continuance) procedures, the auditor should be alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.

Annual Evaluation for Continuing Engagement

An annual evaluation of clients and engagements should be performed as part of the planning process for those engagements. The continuing auditor should consider the topics discussed in this lesson and reassess the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key plan management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in ownership of the plan sponsor, litigation status, compliance with ERISA, scope of the engagement, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, industry risk factors and other considerations may have changed since the initial client acceptance decision. The assessment should also consider matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules. If the firm obtains information that would have caused it to decline an engagement had that information been available previously, SQCS No. 7 requires that policies and procedures on continuance of the engagement and the client relationship include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision should be made in light of the increased knowledge about the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. SAS No. 108 (AU 311) indicates the auditor should perform this review at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client should be made before work commences on the engagement.

ESTABLISHING THE TERMS OF THE ENGAGEMENT

After a new or continuing engagement has been accepted, SAS No. 108 (AU 311), Planning and Supervision, requires the auditor to establish an understanding with the client about the services to be performed for each engagement and to document that understanding through a written engagement letter. Although engagement letters have been a common, but optional, practice for many years, SAS No. 108 eliminated the previous alternative of documenting the understanding with the client in the workpapers only. The issuance of an engagement letter may reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement.

There should be a specific understanding about the financial statements to be audited, such as whether statements of the plan or its trust will be audited; whether the audit is to meet ERISA audit requirements; whether the audit will be a DOL limited-scope audit; and the auditor’s reporting responsibility for schedules, if any, that will accompany the financial statements.

SAS No. 108 indicates that the understanding with the client should include (a) the objectives of the engagement, (b) management’s responsibilities, (c) the auditor’s responsibilities, and (d) limitations of the engagement. The understanding may also include whether the auditor will make use of a specialist (actuary in auditing benefit...
obligations, appraiser in auditing securities that do not have a market price, etc.) or another auditor’s report on a service organization that holds or processes plan investments. However, determining the need to obtain a service auditor’s SAS 70 report involves considerations that may have to wait until the audit planning stage when the auditor has more information about the significance of the service organization’s controls to the plan’s controls. Thus, it may not be possible to reach a definitive understanding about these matters with the client at the pre-engagement stage, and the auditor may need to alert the client of this.

The understanding of the engagement terms may also include any other services to be rendered, for example, preparation of Form 5500.

**Documenting the Terms of the Engagement**

In addition to documenting the required matters mentioned in the preceding paragraphs, an engagement letter can be used to document the fee estimate, expected timing of fieldwork and the report delivery date, expected client clerical assistance during the audit, and arrangements with predecessor auditors, if applicable. Documenting such matters can help prevent misunderstandings. Also, an engagement letter can be an efficient way to provide audit staff with an understanding of the engagement arrangements.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following authoritative pronouncements that affect pre-engagement activities provides requirements related to the issuance of a written engagement letter?
   a. SAS No. 84 (AU 315).
   b. SAS No. 108 (AU 311).
   c. SQCS No. 7 (QC 10).
   d. Interpretation 101-3 (ET 101.05).

2. Which one of the following is not one of the factors an auditor needs to consider when deciding whether to propose for, or accept, an audit engagement?
   a. Ability to meet client requirements that deviate from professional standards.
   b. Ability to meet the engagement’s time requirements.
   c. Audit expertise in the employee benefit plan area.

3. According to Interpretation 101-3, performance of which of the following activities relevant to audits of employee benefit plans would impair an auditor’s independence?
   a. Having full knowledge of plan assets.
   b. Being informed of policy decisions made by plan management.
   c. Making disbursements on behalf of a plan.
   d. Obtaining the concurrence of plan management prior to interpreting the plan document on their behalf.

4. According to the Department of Labor (DOL) regulations, which of the following statements is accurate?
   a. The plan auditor is not allowed to audit the plan sponsor and remain independent.
   b. An accountant can remain independent even if he or she provides actuarial services to the plan.

5. Which of the following attributes of a prospective or continuing client is most significant for an auditor to consider for an employee benefit plan?
   a. Client reputation.
   b. Management reputation.
   c. Management integrity.

6. Of the following statements, which one accurately reflects the actions the predecessor auditor can take in response to the successor’s inquiries?
   a. The predecessor can ethically respond to the successor’s inquiries independent of any authorization by the client.
   b. The predecessor cannot ethically respond to the successor’s inquiries unless the client gives authorization.
7. The DOL limited-scope audit applies to plans with which of the following?
   a. Assets held by a bank.
   b. Third-party administrators.
   c. Claims processors.

8. A DOL limited-scope audit usually results in which of the following actions by the auditor?
   a. An unqualified opinion on the financial statements.
   b. A disclaimer of opinion on the financial statements.
   c. A decision to withdraw from the engagement.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

1. Which of the following authoritative pronouncements that affect pre-engagement activities provides requirements related to the issuance of a written engagement letter? (Page 9)
   
   a. SAS No. 84 (AU 315). [This answer is incorrect. SAS No. 84 (AU 315), Communications Between Predecessor and Successor Auditors, establishes the required communications that should occur prior to client acceptance when a change of auditors has taken place.]
   
   b. SAS No. 108 (AU 311). [This answer is correct. SAS No. 108 (AU 311), Planning and Supervision, provides requirements relating to client acceptance and continuance and establishing an understanding with the client, including the issuance of a written engagement letter.]
   
   c. SQCS No. 7 (QC 10). [This answer is incorrect. SQCS No. 7 (QC 10), A Firm’s System of Quality Control, describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm’s quality control system should encompass.]
   
   d. Interpretation 1013 (ET 101.05). [This answer is incorrect. Interpretation 1013 (ET 1013), Performance of Nonattest Services, of the AICPA’s Code of Professional Conduct, provides guidance regarding an auditor’s independence in relationship to an attest client when performing nonattest services.]

2. Which one of the following is not one of the factors an auditor needs to consider when deciding whether to propose for, or accept, an audit engagement? (Page 12)
   
   a. Ability to meet client requirements that deviate from professional standards. [This answer is correct. The auditor should never attempt to meet client requirements that deviate from professional standards since it would negate the reason for the audit.]
   
   b. Ability to meet the engagement’s time requirements. [This answer is incorrect. Prior to deciding to propose for, or accept an audit, the auditor should consider his or her ability to meet the engagement’s time requirements and deadlines so that the audit will be completed on a timely basis and the Form 5500 will be filed by the deadline.]
   
   c. Audit expertise in the employee benefit plan area. [This answer is incorrect. The auditor should consider his or her expertise in the employee benefit plan area or the ability to obtain sufficient knowledge to meet professional standards. If the auditor does not possess the expertise or cannot attain it, they should not propose or accept the audit.]

3. According to Interpretation 101-3, performance of which of the following activities relevant to audits of employee benefit plans would impair an auditor’s independence? (Page 14)
   
   a. Having full knowledge of plan assets. [This answer is incorrect. Having full knowledge of plan assets would not impair an auditor’s independence but would enhance the auditor’s ability to perform the audit. However, having custody of plan assets would impair an auditor’s independence.]
   
   b. Being informed of policy decisions made by plan management. [This answer is incorrect. Making policy decisions on behalf of plan management would impair an auditor’s independence, but not simply being informed of policy decisions that plan management has made. The more information that an auditor has about the plan, the better they are able to complete the audit.]
   
   c. Making disbursements on behalf of a plan. [This answer is correct. Making disbursements on behalf of a plan would influence an auditor’s decision-making and would, therefore, impair an auditor’s independence.]
d. Obtaining the concurrence of plan management prior to interpreting the plan document on their behalf. [This answer is incorrect. An auditor’s independence would be impaired when dealing with plan participants if he or she interpreted the plan document on behalf of plan management without first obtaining the concurrence of plan management. But if the auditor obtains the concurrence of plan management first, their independence should not be impaired.]

4. According to the Department of Labor (DOL) regulations, which of the following statements is accurate? (Page 17)

   a. The plan auditor is not allowed to audit the plan sponsor and remain independent. [This answer is incorrect. The DOL regulations do allow the plan auditor to audit the plan sponsor and remain independent.]

   b. An accountant can remain independent even if he or she provides actuarial services to the plan. [This answer is correct. DOL regulations allow an accountant, or his or her firm, to provide actuarial services to the plan and remain independent.]

5. Which of the following attributes of a prospective or continuing client is most significant for an auditor of an employee benefit plan to consider? (Page 18)

   a. Client reputation. [This answer is incorrect. Although the reputation of a prospective or continuing client is an important factor for an auditor to consider, it is not the most important factor for an employee benefit plan.]

   b. Management reputation. [This answer is incorrect. The reputation of a prospective or continuing client’s management is another factor that an auditor should always consider but, likewise, is not the most critical factor to consider for an employee benefit plan.]

   c. Management integrity. [This answer is correct. Management integrity is especially significant for an employee benefit plan due to the responsibilities ERISA imposes on plan administrators and other fiduciaries.]

6. Of the following statements, which one accurately reflects the actions the predecessor auditor can take in response to the successor auditor’s inquiries? (Page 19)

   a. The predecessor can ethically respond to the successor’s inquiries independent of any authorization by the client. [This answer is incorrect. The predecessor cannot ethically respond to the successor’s inquiries unless the client gives authorization.]

   b. Unless the client gives authorization, the predecessor cannot ethically respond to the successor’s inquiries. [This answer is correct. The predecessor cannot ethically respond to the successor’s inquiries unless the client gives authorization because of the requirement for confidentiality in Rule 301 of the AICPA Code of Professional Conduct.]

7. The DOL limited-scope audit applies to plans with which of the following? (Page 20)

   a. Assets held by a bank. [This answer is correct. The limited-scope audit is permitted by DOL regulations for plans with assets held by a bank or similar institution, or insurance company that is supervised and regulated and subject to periodic examination by a state or federal agency.]

   b. Third-party administrators. [This answer is incorrect. The limited-scope audit does not apply to third-party administrators. Since in a DOL limited scope audit, the auditor does not apply audit procedures to information on plan investment assets and related transactions that is prepared and certified to as both complete and accurate by the financial institution.]

   c. Claims processors. [This answer is incorrect. The limited-scope audit does not apply to service organizations such as claims processors or mortgage servicing agents. Since they do not hold the assets, they cannot certify the assets as complete and accurate.]
d. Investment companies. [This answer is incorrect. AEBP, Paragraph 5.13 states that the DOL limited-scope audit does not apply to assets held by a broker, dealer, or an investment company. Since they do not hold the assets, they cannot certify the assets as complete and accurate.]

8. A DOL limited-scope audit usually results in which of the following actions by the auditor?  
   (Page 21)
   
   a. An unqualified opinion on the financial statements. [This answer is incorrect. An auditor is precluded from giving an unqualified opinion due to the scope restriction.]
   
   b. A disclaimer of opinion on the financial statements. [This answer is correct. A DOL limited-scope audit usually results in a disclaimer of opinion on the financial statements and supplemental schedules because of the scope limitation.]
   
   c. A decision to withdraw from the engagement. [This answer is incorrect. A DOL limited-scope audit is not justification for the auditor to withdraw from the engagement.]
   
   d. A qualified opinion on the financial statements. [This answer is incorrect. A qualified opinion is appropriate when only a portion of the plan’s investments are covered by the limited-scope certification.]
AUDIT PLANNING

Objectives of Audit Planning

The first standard of fieldwork states that “the auditor must adequately plan the work and must properly supervise any assistants” (AU 150.02). According to SAS No. 108 (AU 311.02), Planning and Supervision, “audit planning involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit.” Audit strategy is the auditor’s operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope. It includes matters such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

An overriding objective throughout the planning process is the identification of risks that should be considered and an assessment of whether the risks could result in material misstatement of the financial statements. According to SAS No. 108 (AU 311), obtaining an understanding of the plan and its environment, including its internal control, is an essential part of planning the audit. Auditors must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditors’ understanding of the plan and its environment, including its internal control.

Audit planning also includes developing audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The nature, timing and extent of audit planning varies with type of plan, the size and complexity of the plan, the auditor’s experience with the plan, and with the auditor’s understanding of the plan and its environment, including internal control. However, audit planning always includes a risk assessment process.

Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the plan and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, such as preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor is required to perform all of these procedures when planning the audit. Further, the auditor’s consideration of fraud required by SAS No. 99 (AU 316), Consideration of Fraud in a Financial Statement Audit, is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. The key requirements of SAS No. 99 are addressed at relevant points throughout this course.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the plan and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors.

b. Nature of the plan.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

e. Internal control, which includes the selection and application of accounting policies.

f. Fraud risk factors.

**Decisions and Judgments Made.** The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.

**Summary of Risk Assessment Process.** Exhibit 1-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

**Exhibit 1-1**

The Risk Assessment Process

<table>
<thead>
<tr>
<th>Procedures Performed</th>
<th>Understanding Obtained</th>
<th>Decisions and Judgments Made</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary engagement activities.</td>
<td>Industry, regulatory, and other external factors.</td>
<td>Decisions at the Financial Statement Level:</td>
</tr>
<tr>
<td>Inquiries of plan management and others.</td>
<td>Nature of the plan.</td>
<td>- Materiality at the financial statement level.</td>
</tr>
<tr>
<td>Preliminary analytical procedures.</td>
<td>Objectives, strategies, and related business risks.</td>
<td>- Materiality for particular items of lesser amounts.</td>
</tr>
<tr>
<td>Observation and inspection.</td>
<td>Measurement and review of the plan’s financial performance.</td>
<td>- Risks of material misstatement at the financial statement level.</td>
</tr>
<tr>
<td>Discussion among the engagement team.</td>
<td>Internal control.</td>
<td>- Overall audit strategy.</td>
</tr>
<tr>
<td></td>
<td>Selection and application of accounting policies.</td>
<td>Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level:</td>
</tr>
<tr>
<td></td>
<td>Fraud risk factors.</td>
<td>- Tolerable misstatement.</td>
</tr>
</tbody>
</table>

* * *

**The Sequence of Audit Planning**

Because an audit of financial statements is an iterative process, audit planning is not a discrete phase of the audit. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. Audit planning begins with engagement acceptance and continues throughout the remainder of the audit. Also, many of the audit planning steps and procedures can be performed simultaneously and tend to blend together. Nevertheless, having a logical sequence of steps and procedures provides a useful framework. A suggested approach is presented in Exhibit 1-2.
Exhibit 1-2

Steps in the Audit Process Related to Planning

Preliminary Engagement Activities

1. Perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement.

2. Evaluate compliance with ethical requirements, including independence.

3. Establish an understanding with the client and communicate in an engagement letter.

General Audit Planning at the Financial Statement Level

4. Establish preliminary audit strategy.

5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.

6. Determine the materiality level for the financial statements taken as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.

7. Perform preliminary analytical procedures (a risk assessment procedure).

8. Hold a discussion among the engagement team.

9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks of material misstatement.

10. Assess audit risk at the overall financial statement level.

11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine tolerable misstatement (often in conjunction with Step 6).

13. Assess audit risk in relation to relevant assertions for transactions classes, account balances, and disclosures.

14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

*          *         *

Depending on the auditor’s knowledge and past experience with the client, as well as other factors, certain planning steps might be performed at differing stages or sequences from one engagement to the next. For example, the sixth step, determine the materiality level for the financial statements taken as a whole, and the twelfth step, determine tolerable misstatement, are often performed concurrently. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances, but should occur relatively early in planning, and it is not required to occur in any particular sequence.

As stated previously, an overriding objective throughout the planning process is the identification of risks that should be assessed as to whether they could result in material misstatement of the financial statements. SAS No. 106 (AU 326.21) clearly indicates the role of the risk assessment procedures within this process as follows:

The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.
Obtaining an understanding of the plan and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as risk assessment procedures because the information obtained by performing those procedures is used to support the auditor’s assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. Standards encourage this by requiring the use of a variety of risk assessment procedures when obtaining an understanding of the plan and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to providing information about the plan and its environment, including its internal control, performing risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures.

**Types of Risk Assessment Procedures**

The risk assessment and other planning procedures required by SAS Nos. 108 (AU 311) and 109 (AU 314) to obtain information about the plan and its environment, including its internal control, and to assess the risks of material misstatement include the following:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of plan management and others.

c. Preliminary analytical procedures.

d. Observation and inspection, such as visits to the plan’s or plan sponsor’s premises and tracing transactions through the information system (that is, walkthroughs).

e. Discussion among the engagement team.

Each of the procedures listed are explicitly required during risk assessment and, except for observation and inspection, are also explicitly enumerated in SAS No. 99 (AU 316) as sources of information that should be considered when identifying risks of material misstatement due to fraud. SAS No. 109 requires that all of the risk assessment procedures be performed when obtaining an understanding of the plan and its environment. However, there is no requirement that each of those procedures be performed for every component of the required understanding.

**Nature, Timing, and Extent—General Considerations.** The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will require tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the plan to whom related questions may be directed will depend on the circumstances and the specific information gathered about the plan. For example, if initial inquiries reveal that the plan holds hard-to-value investments, the auditor will likely make further inquiries of personnel involved in the valuation of those investments. Thus, performing risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the plan and its environment. According to AEBP, Paragraph 5.53, in an employee benefit plan audit, the nature and extent of risk assessment procedures vary based on the auditor’s prior experience with the plan, the auditor’s prior experience with any service providers, changes in the operating environment of the plan, the type and complexity of the plan, the client’s financial sophistication, and new accounting or other regulatory requirements (DOL, IRS, or PBGC).

**Gathering Other Information Needed to Identify Fraud Risks.** In connection with obtaining an understanding of the plan and the employee benefit plan industry, auditors may become aware of information that is relevant to
identifying fraud risks. In addition, auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of plan management and others about the risks of fraud and how they are addressed.
- Consider the results of preliminary analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information.

**Using the Results of Risk Assessment Procedures Performed in Prior Periods.** Because professional standards require the performance of risk assessment procedures to obtain an understanding of the plan and provide a basis for the assessment of risks, the question naturally arises of whether the auditor can use information gathered from procedures performed in a prior period and limit the extent of current year procedures? The answer is a qualified “yes.”

The process of understanding the plan and its environment is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor’s previous experience with the plan also contributes to the understanding of the plan and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The plan’s organizational structure, operations, and controls.
- Past misstatements and whether they were corrected on a timely basis.

Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, the auditor should determine whether changes have occurred that may affect its relevance in the current audit. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; participant benefits; contingencies; nature of the plan’s operations; plan management; financial condition; conditions and events or operating results that are relevant to the going concern assumption; regulatory compliance; litigation status; control environment or activities; fraud risks; plan management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the client’s business risk or the auditor’s assessment of risks of material misstatement. Therefore, the auditor should perform some risk assessment procedures in the current audit to determine whether changes have occurred that impact the relevance of information gathered in previous audits. For example, auditors might perform inquiries of key client personnel, supplemented by observation and inspection (for example, review of interim financial reports and walkthroughs) to determine if changes have occurred.

As a result, although the nature of the auditor’s procedures always includes inquiries, observation, and inspection, it is believed the extent of risk assessment procedures will often be considerably less in continuing engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement or risk of material misstatement identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

**Inquiries of Plan Management and Others**

Inquiry of plan management and others is used extensively throughout the audit planning process. In many cases, it serves as a foundation for the performance of other risk assessment procedures in that the responses obtained
drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. For example, an auditor might ask plan management about the valuation of investments. The auditor would then evaluate the response obtained and determine if a potential risk exists. In this case, the auditor is concerned about potential inappropriate valuation of investments. If the auditor deems that there is an indication of this risk, additional inquiries might be posed to further identify the risk and determine whether other risk assessment procedures are necessary.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. Auditors are required to use inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

**Matters and Parties of Inquiry.** The auditor should inquire of management about the following matters:

- **a.** The aspects of the plan and its environment as enumerated in SAS No. 109 (AU 314.21).
- **b.** The information about fraud, suspected fraud, fraud-related programs and controls, and risks of fraud as enumerated in SAS No. 99 (AU 316.20–21).

The auditor might decide that inquiries of others within and outside the plan, in addition to plan management and those responsible for financial reporting, would be useful. Examples of other inquiries that might be made include the following:

- **a.** *Those Charged with Governance.* Their involvement in the financial reporting process and how financial statements are used. [SAS No. 99, (AU 316.22), requires the auditor to inquire directly of those charged with governance for the audit committee (or at least its chair), about the risks of fraud and their knowledge of fraud or suspected fraud.]
- **b.** *Internal Audit.* Activities concerning the design and effectiveness of internal control and management’s responses to any findings by the internal audit function, if the plan has an internal audit function. [SAS No. 99, (AU 316.23), requires inquiry of internal audit personnel about risks of fraud, knowledge of fraud or suspected fraud, and activities concerning fraud detection.]
- **c.** *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support plan management’s responses. [SAS No. 99, (AU 316.24), requires inquiry of others within the plan, determined through the auditor’s judgment, about the existence or suspicion of fraud. These employees may actually be employees of the plan sponsor who perform procedures for the plan.] Auditors may consider obtaining the perspective of employees from different functional areas (such as treasury, finance, payroll, or human resources) and at varying levels of authority when identifying risks of material misstatement.
- **d.** *Parties Outside the Plan.* Inquiries of parties outside the plan are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of personnel at service providers that provide administrative services to the plan or of valuation experts that plan management has engaged. The auditor might also find it useful to make inquiries of plan participants or beneficiaries receiving payments to better understand the nature of the plan and its operations.

**Fraud-related Inquiries.** The auditor should integrate the requirements of SAS No. 99 (AU 316) into the risk assessment process. As part of gathering the information needed to identify fraud risks, SAS No. 99 (AU 316.20) requires auditors to inquire of management and others about:

- Their knowledge of any actual fraud or suspicions of fraud affecting the plan.
- Their awareness of any allegations of fraud or suspected fraud affecting the plan.
- Their understanding of the risks of fraud within the plan, including any specific fraud risks the plan has identified or account balances or transaction classes that may be susceptible to fraud.
• How they communicate to employees the importance of ethical behavior and appropriate business practices.

• Programs and controls the plan has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.

• If applicable, the nature and extent of monitoring multiple locations and whether any of them have a higher level of fraud risk.

• Whether they have reported to those charged with governance about how the plan’s internal control serves to prevent, deter, and detect material misstatements due to fraud.

The objective of the inquiry includes obtaining different perspectives on financial statement areas and organizational areas and locations with a risk of fraud and identifying whether anyone has suspicions or actual knowledge of fraud. Examples of management and others that auditors may consider interviewing include:

• The plan administrator.

• Members of the plan’s administrative committee or board of trustees.

• Members of the plan’s investment committee.

• The plan’s actuary.

• Employee of the plan’s sponsor(s).

• Plan participants.

Documentation. SAS No. 109 (AU 314.122) requires documentation of risk assessment procedures performed in obtaining an understanding of the plan and its environment. When documenting inquiry procedures, SAS No. 103 (AU 339.21), Audit Documentation, requires audit documentation to include the identifying characteristics of the specific items tested. In conjunction with this requirement, the standard provides an example for documenting inquiries of specific personnel indicating that auditors may document the date of the inquiry, name and job description of the individual queried, and the nature of the inquiry. Documenting these identifying characteristics when performing risk assessment inquiry procedures is recommended.

Preliminary Analytical Procedures

SAS No. 56 (AU 329.04) states that analytical procedures should be applied to some extent in all audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures. To accomplish this, SAS No. 56 (AU 329.06) indicates that analytical procedures used in planning the audit should focus on—

a. Enhancing the auditor’s understanding of the client’s business and the transactions and events that have occurred since the last audit date.

b. Identifying areas that may represent specific risks relevant to the audit.

Knowledge of the client and its environment is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the plan and its environment before performing preliminary analytical procedures. The auditor’s knowledge and understanding of the plan can also be improved by applying preliminary analytical procedures in audit planning.

SAS No. 56 does not require the use of any particular analytical procedures. It recognizes that the sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. For
an employee benefit plan, effective analytical procedures need not be complex. A comparison of significant account balances with prior period amounts can improve the auditor’s understanding of the plan and its operations. Are there significant fluctuations in contributions received and receivable, benefit payments, and investments? Do changes in contributions and benefit payments make sense in relation to changes in the number of participants, the number eligible to receive benefits, and the number of terminations? Do changes in the composition of the investment portfolio make sense in relation to the plan’s investment strategy and operating needs? Is investment income reasonable considering market conditions and the composition and changes in the portfolio in comparison to prior years?

SAS No. 99 (AU 316.29) specifically requires auditors to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. As the financial statements of employee benefit plans do not report revenues, AEBP, Paragraph 5.100, indicates the risk of misstatement due to fraudulent financial reporting primarily relates to investment income arising from inappropriate investment valuation and to contributions being recognized inappropriately. AEBP, Paragraph 5.96, cites as an example of an analytical procedure relating to revenue the comparison of investment returns to industry benchmarks for the type of investment. Analytical procedures that may be useful in considering the risk of fraudulent financial reporting include:

- **Analysis of Relationships Between Financial and Nonfinancial Amounts.** When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to other financial items and (b) could not easily be manipulated by plan management or the plan sponsor. For example, auditors may compare participant contributions (in a contributory plan) to active employees for the period. The number of active employees is an amount that is not easily manipulated, particularly when the number of active participants is obtained from an outside service provider. Changes in the number of active employees without a corresponding change in average participant contributions may indicate fraudulent financial reporting.

- **Trend Analysis.** Auditors may analyze trends in the components of additions to net assets or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example, a trend analysis of participant contributions by month (in a contributory plan) during and shortly after the reporting period may indicate the plan sponsor failed to timely remit participant contributions to the plan.

- **Ratio Analysis.** Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement item to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations.

When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement of the financial statements. Because an employee benefit plan audit frequently starts well after the plan’s year has ended, preliminary analytical procedures can readily be performed during audit planning using a comparative trial balance and statistical data maintained on participants. This information is usually available before audit planning begins.

**Observation and Inspection**

Observation and inspection procedures are required when obtaining an understanding of the plan and its environment, including its internal control. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the plan and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, to gain an understanding of the plan’s benefit obligations, the auditor might decide to review the plan document. That procedure, coupled with a review of the plan’s financial statements, might be the key procedure that helps the auditor identify risks related to potential misstatement of the plan’s obligations.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of plan management and others. For example, through inquiries of plan management, the auditor may become aware of plan investments that may be difficult to value (such as nonreadily marketable securities). In response, the
The auditor may choose to review minutes of the investment committee or the investment policy statement to identify risks of improper valuation.

Other than the requirement to perform some observation and inspection procedures related to internal control, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor’s judgment. Ordinarily, it is believed that observation and inspection procedures are effective in the following situations when obtaining an understanding of the plan:

- To understand the design of controls related to the audit.
- To verify that controls have been implemented, for example, as part of a walkthrough.
- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When required information can only or best be obtained through observation or inspection.
- When the evidence gathered through observation and inspection can also be used for a substantive procedure.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

**Documentation.** SAS No. 109 (AU 314.122) requires documentation of risk assessment procedures performed in obtaining an understanding of the plan and its environment. SAS No. 103 (AU 339.21) documentation of the identifying characteristics of specific items tested and provides examples for documenting the identifying characteristics of observation and inspection procedures. Based on that guidance, documenting the following is recommended:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, the authors recommend referring to the report or document by the same name that the client uses to refer to it.)

- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

**Discussion among the Engagement Team**

SAS No. 109 (AU 314.14) requires the members of the audit team to discuss the susceptibility of the plan’s financial statements to material misstatements. SAS No. 99 (AU 316.14) requires an exchange of ideas, or “brainstorming” among audit team members about how and where they believe the plan’s financial statements might be susceptible to material misstatement due to fraud, how plan management could perpetrate and conceal fraudulent financial reporting, and how assets of the plan could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

The focus of the audit team discussion should be on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the more experienced members of the audit team can share their insights based on their cumulative knowledge of the plan, the employee benefit plan industry, and the plan’s environment.
**Matters to be Discussed.** This discussion is aimed at the susceptibility of the financial statements to material misstatement, that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion should not be a narrow one focused on risks already identified, but one that opens the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, should be communicated to the team members. Among other matters, SAS No. 109 (AU 314.18) indicates that the discussion should include the following:

- a. Critical issues and areas of significant audit risk.
- b. Areas susceptible to plan management override of controls.
- c. Unusual accounting practices used by the plan.
- d. Application of GAAP to the plan’s facts and circumstances in light of its accounting policies.
- e. Important control systems.
- f. Materiality at the financial statement level (planning materiality) and at the account level (tolerable misstatement).
- g. How materiality will be used to determine the extent of testing.
- h. The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

It is believed the discussion also should address how the risks facing the plan could result in a material misstatement of the financial statements, focusing especially on changes from the prior year and new developments. Examples of other factors the engagement team might discuss that affect the likelihood of material misstatements caused by error include the following:

- Past experience with the client.
- Changes in the plan’s organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client’s personnel and assignment of responsibilities. For some smaller plans, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles, especially if concerns had been noted in previous audits.

SAS No. 99 (AU 314.–.15) indicates that the discussion should also include the following fraud-related matters:

- How and where the plan’s financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.
- How plan management could perpetrate and conceal fraudulent financial reporting.
- How the plan’s assets could be stolen and the theft concealed.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
The fraud aspect of the discussion should give appropriate consideration to financial statement misstatement from both fraudulent financial reporting (i.e., “cooking the books”) and stealing. A key consideration when assessing fraud risk is what motivations may exist for plan management to intentionally misstate the financial statements or what controls may be lacking that could result in theft. By identifying the motives and opportunities for fraud, the auditor should be able to assess the direction of the risk.

The discussion should also include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud (for example, by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks). The discussion should foster an open exchange of ideas (that is, brainstorming). Participants should maintain an attitude of professional skepticism throughout the discussion. Both SAS No. 99 and SAS No. 109 refer to a discussion; therefore, one-sided communication, such as a memo from the engagement partner, is not appropriate. (However, when the entire engagement is performed by a single auditor, SAS No. 109 (AU 314.14) notes that the auditor can simply consider and document the susceptibility of the plan's financial statements to material misstatements.) The medium for discussion (for example, a meeting or a conference call) should encourage interaction and an appropriate exchange of ideas. Although SAS Nos. 99 and 109 both require the engagement team to have a specific discussion, communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

The discussion should not be influenced by past favorable experience with the integrity of plan management. In fact, SAS No. 99 states that the engagement team should abandon neutrality and any preconceptions about plan management’s and employees’ honesty, but instead presume the possibility of dishonesty at various levels of plan management. Thus, for example, auditors may use “what if” scenarios that focus on the financial statement areas vulnerable to fraud with the presumption that plan management or employees are inclined (either because of incentives/pressures or attitudes/rationalizations) to perpetrate fraud. Engagement team members should not rely on less than persuasive audit evidence because of a belief that plan management or employees are honest.

**Effect on Significant Audit Areas.** After discussing the risks that could result in a material misstatement of the financial statements and determining how those risks affect specific audit areas, it is recommended that the engagement team then discuss each significant audit area. The team should discuss the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team should avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. In fact, it may be best to ignore the prior year workpapers when initially discussing each significant area. That way, the audit team starts with a clean slate when developing the audit approach and avoids the temptation to just rely on “what we did last year.” The result is usually a more effective and efficient audit approach. However, after the team has discussed each significant area, the prior year workpapers should be reviewed to make sure there are not any issues that were overlooked.

**Who Should Attend the Discussion?** Both SAS No. 99 and SAS No. 109 require auditors to exercise judgment in determining who should attend the discussion among the engagement team, but they indicate that the discussion should include the auditor with final responsibility for the audit (generally the audit partner) and ordinarily should comprise key members of the engagement team. Also, it may be appropriate to include specialists, such as actuaries, assigned to the engagement team and personnel assigned to the audit of the plan sponsor. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the plan’s accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statement to material misstatements from error or fraud. For audits involving multiple locations, such as multi-employer plans, there may be several discussions so that team members in all locations are involved. It is recommended that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion.

**When Should the Discussion Occur?** Before holding the discussion with the engagement team, it is recommended that the in-charge auditor and/or engagement partner have preliminary planning discussions with the client. Issues to discuss with the client include the services to be provided, scheduling, and other administrative matters. In addition, the auditor should discuss the plan’s environment (particularly changes from the prior year), the client’s view of the risks that the client is addressing, and other specific issues facing the client. The auditor should also obtain additional information to be used in the planning process prior to meeting with the engagement team.
The timing of the engagement team discussion and other logistics depend on the circumstances and are not addressed in SAS No. 109, other than to note that for audits involving multiple locations, there may be discussions involving engagement team members in those locations. SAS No. 99 (AU 316.14) states only that the engagement team discussion may occur before or while obtaining an understanding of the plan and gathering the information needed to identify fraud risks. It is believed that it is important to set the proper tone of professional skepticism and to inform less experienced staff members about the risks of material misstatement before performing those procedures. However, nothing prevents the firm from holding discussions both before and during the information-gathering process. These decisions are normally made by the auditor with final responsibility for the audit, and firms should exercise professional judgment to determine what works best in their particular audit process. In any case, engagement team members should communicate and share information obtained throughout the audit about the risks of material misstatement due to error or fraud.

**Other Matters That May Be Discussed.** The engagement team discussion also provides an opportunity for the in-charge auditor or partner to remind the audit team members of the audit documentation requirements of SAS No. 103 (AU 339) that they should observe while performing audit procedures, including the following:

1. Inclusion of abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant transactions.
2. Identification of items tested in tests of operating effectiveness of controls.
3. Identification of documents inspected or items confirmed in substantive tests of details.
4. Documentation relating to substantive analytical procedures used as the principal substantive test of significant financial statement assertions.
5. Documentation relating to consideration of the plan’s ability to continue as a going concern.
6. Documentation of the nature and effect of aggregated misstatements and the conclusion as to whether they cause material misstatement of the financial statements.
7. Documentation of who performed and reviewed the audit work and the date the work was performed and reviewed.

**Documentation of the Discussion.** SAS No. 109 requires specific items be documented regarding the discussion among the audit team. These requirements are similar to the documentation requirements of SAS No. 99 regarding the fraud-related discussion among the audit team.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Which of the following documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence?
   a. Audit strategy.
   b. Audit plan.

10. Michael is working on planning the audit of the 401(k) plan for Woodhouse Furniture. He is working his way through the steps in the audit process for planning and just finished deciding on the preliminary audit strategy for the audit of the benefit plan. What should Michael’s next step in his audit planning be?
   a. Decide on the audit’s general materiality level for the financial statements.
   b. Assemble the engagement team and have a planning meeting.
   c. Execute risk assessment procedures based on the evaluation of nature, timing and extent of risk in the audit.
   d. Prepare a detailed audit plan, determining the audit procedures of the audit.

11. Katy has been engaged to audit the benefit plan of Smartwear Electronics. Katy’s firm audited the benefit plan last year. Can Katy utilize information that the audit team assembled from the previous audit in the completion of the current year audit?
   a. Yes.
   b. No.

12. As required by SAS No. 99, Consideration of Fraud in a Financial Statement Audit, examples of management and others identified in the text that auditors may consider interviewing when making fraud-related inquiries include any of the following except:
   a. The plan administrator.
   b. Plan participants of a similar plan.
   c. The plan’s actuary.
   d. Plan participants.

13. Braden is currently planning the benefit plan audit of Wholesome Foods, Inc. He is trying to determine what analytical procedures need to be included in the planning stage of the audit. What authoritative literature could provide Braden with information regarding analytical procedures in the planning stage of the benefit plan audit?
   a. SAS No. 56 (AU 329.04).
   b. SAS No. 99 (AU 316.23).
   c. SAS No. 103 (AU 339.21).
   d. SAS No. 109 (AU 314.122).
14. When engaging in discussions concerning material misstatement, the engagement team should approach the subject in which of the following ways?

   a. Use past favorable experience with the integrity of plan management as a basis for assessing the current engagement.

   b. Maintain neutrality and rely on preconceptions concerning plan management’s and employees’ honesty.

   c. Enter the discussions with no preconceptions and presume the possibility of dishonesty at all levels of plan management.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

9. Which of the following documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence? (Page 32)

a. Audit strategy. [This answer is incorrect. The audit strategy is the auditor’s operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope. It includes things such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area.]

b. Audit plan. [This answer is correct. The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The nature, timing and extent of audit planning varies with type of plan, the size and complexity of the plan, the auditor’s experience with the plan, and with the auditor’s understanding of the plan and its environment, including internal control. However, audit planning always includes a risk assessment process.]

10. Michael is working on planning the audit of the 401(k) plan for Woodhouse Furniture. He is working his way through the steps in the audit process for planning and just finished deciding on the preliminary audit strategy for the audit of the benefit plan. What should Michael’s next step in his audit planning be? (Exhibit 1-2)

a. Decide on the audit’s general materiality level for the financial statements. [This answer is incorrect. Before Michael can determine the materiality level for the financial statements taken as a whole in the planning stage of the audit of the benefit plan, he has to assess the risk of the audit. Deciding on the audit’s general materiality level for the financial statements would not be the next step for Michael after he has determined his preliminary audit strategy for the audit of the benefit plan.]

b. Assemble the engagement team and have a planning meeting. [This answer is incorrect. Although Michael needs to have a planning session with his audit team to make decisions on how to conduct the audit of the plan, it is not the next step in the process for Michael after he decides on the preliminary audit strategy based on the steps detailed in the planning process.]

c. Execute risk assessment procedures based on the evaluation of nature, timing and extent of risk in the audit. [This answer is correct. The next step in the planning phase of the audit process after Michael has determined his primary audit strategy is to decide the nature, timing, and extent of risk assessment procedures and perform the procedures. Numerous items in the planning phase are dependent on the risk assessment, so it is imperative that the auditor include risk assessment in the planning phase of the audit.]

d. Prepare a detailed audit plan, determining the audit procedures of the audit. [This answer is incorrect. Numerous items must be completed in the planning phase of the audit for the auditor to be able to create a detailed audit plan. Michael would not be able to develop a detailed audit plan after deciding on the preliminary audit strategy. He would need to assess risk, determine materiality level, and identify fraud risk factors to name a few steps before preparing a detailed audit plan.]

11. Katy has been engaged to audit the benefit plan of Smartwear Electronics. Katy’s firm audited the benefit plan last year. Can Katy utilize information that the audit team assembled during the previous audit in the completion of the current year audit? (Page 36)

a. Yes. [This answer is correct. Using audit procedures performed in previous audits ordinarily provides useful audit evidence concerning the plan’s organizational structure, operations, and controls. Past misstatements may also be identified and reveal whether they were corrected on a timely basis.]

b. No. [This answer is incorrect. Auditors can use information gathered from procedures performed in a prior period to limit the extent of current year procedures.]
12. As required by SAS No. 99 (AU 316.20), *Consideration of Fraud in a Financial Statement Audit*, examples of management and others identified in the text that auditors may consider interviewing when making fraud-related inquiries include any of the following except: (Page 37)

a. The plan administrator. [This answer is incorrect. The plan administrator is one member of management that auditors may consider interviewing when making fraud-related inquiries since the plan administrator can provide the auditor with useful information for fraud investigation.]

b. Plan participants of a similar plan. [This answer is correct. Plan participants of a similar plan would not be useful for the auditor to interview when making fraud-related inquiries. These individuals would have no specific knowledge of fraud risks for the plan currently being audited.]

c. The plan’s actuary. [This answer is incorrect. The plan’s actuary is another example of an individual that may provide valuable information related to fraud-related inquiries made by the auditor since the objective of the inquiry is to obtain different perspectives on the plan.]

d. Plan participants. [This answer is incorrect. Plan participants may be one of the most candid and valuable sources of information for the auditor when making fraud-related inquiries. They can tell you if they have had any issues with contribution amounts or investment changes.]

13. Braden is currently planning the benefit plan audit of Wholesome Foods, Inc. He is trying to determine what analytical procedures need to be included in the planning stage of the audit. What authoritative literature could provide Braden with information regarding analytical procedures in the planning stage of the benefit plan audit? (Page 38)

a. SAS No. 56 (AU 329.04). [This answer is correct. SAS No. 56 (AU 329.04) indicates that analytical procedures should be applied to some extent in all audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures by focusing on enhancing the auditor’s understanding of the client’s business and the transactions and events that have occurred since the last audit date, and identifying areas that may represent specific risks relevant to the audit.]

b. SAS No. 99 (AU 316.23). [This answer is incorrect. SAS No. 99 (AU 316.23) requires inquiry of internal audit personnel about risks of fraud, knowledge of fraud or suspected fraud, and activities concerning fraud detection.]

c. SAS No. 103 (AU 339.21). [This answer is incorrect. SAS No. 103 (AU 339.21) requires audit documentation to include the identifying characteristics of the specific items tested.]

d. SAS No. 109 (AU 314.122). [This answer is incorrect. SAS No. 109 (AU 314.122) requires documentation of risk assessment procedures performed in obtaining an understanding of the plan and its environment.]

14. When engaging in discussions concerning material misstatement, the engagement team should approach the subject in which of the following ways? (Page 42)

a. Use past favorable experience with the integrity of plan management as a basis for assessing the current engagement. [This answer is incorrect. Past favorable experience regarding the integrity of plan management should not be a basis for assessing the current engagement. Each engagement and associated plan management must stand on its own merits.]

b. Maintain neutrality and rely on preconceptions concerning plan management’s and employees’ honesty. [This answer is incorrect. Neutrality should be abandoned with each new engagement and preconceptions set aside concerning the honesty of plan management and employees.]

c. Enter the discussions with no preconceptions and presume the possibility of dishonesty at all levels of plan management. [This answer is correct. Discussions should be held assuming the possibility that dishonesty may exist at any level of plan management and, as a result, avoid relying on less than persuasive audit evidence.]
EXAMINATION FOR CPE CREDIT
Lesson 1 (EBPTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook.

1. Which of the following authoritative pronouncements establishes the level of understanding of the plan and its environment that the auditor should obtain for preliminary planning purposes?
   a. SAS No. 56 (AU 329).
   b. SAS No. 107 (AU 312).
   c. SAS No. 109 (AU 314).
   d. SAS No. 110 (AU 318).

2. When deciding whether to retain an existing client, how frequently should the auditor consider his or her ability to accept the engagement, plan management’s integrity, and the scope of the proposed audit?
   a. Every 90 days.
   b. Every 180 days.
   c. Annually.
   d. Bi-annually.

3. For the auditor to remain independent, when performing nonattest services, the client must agree to perform a number of functions in connection with the engagement. Which of the functions listed below does not accurately describe the client’s responsibilities?
   a. Make key management decisions and perform critical management functions.
   b. Assign an individual who possesses suitable qualifications to oversee the services.
   c. Assess the adequacy and the results of the services performed.
   d. Acknowledge responsibility for the results of the services.

4. Which of the following ethics rulings states that a firm providing investment management or custodial services for an employee benefit plan would not be independent of the plan?
   a. Ethics Ruling No. 21.
   b. Ethics Ruling No. 60.
   c. Ethics Ruling No. 107.
   d. Ethics Ruling No. 111.

5. If the auditor fails to meet the ERISA and DOL audit and reporting requirements, the plan administrator can be subject to:
   a. A written warning.
   b. Substantial fines.
   c. Suspension of his or her accounting license.
   d. Removal from the engagement.
6. Abby has just accepted an engagement to audit the benefit plan of PKB Financials. The client has used the same auditors for the previous ten years. Abby is wondering why the client has decided to change auditors in the current year. Where can Abby find this information in the Form 5500?
   a. Schedule A.
   b. Schedule B.
   c. Schedule C.
   d. Schedule F.

7. When performing a DOL limited-scope audit, the auditor should accomplish which of the following with regard to the investments covered by the limited scope certification?
   a. Attain an understanding of the certifying institution’s internal control over investments held and investment transactions executed on behalf of the plan.
   b. Evaluate control risk associated with investments held and related transactions executed by the certifying institution.
   c. Examine the accuracy or completeness of the certified investment information if the auditor believes the information from the trustee or custodian is unsatisfactory.
   d. Determine whether the certifying institution is qualified to issue a limited scope certification based on DOL regulations.

8. Becky is preparing a proposal to audit the benefit plan of Pumpkin Seed Foods. Which of the following issues would require extra work that Becky should factor into her proposal and fee estimate?
   a. The number of benefit plan participants has increased by 10% from the previous year.
   b. The benefit plan has never been audited before.
   c. The benefit plan was previously audited by another firm.
   d. Do not select this answer choice.

9. Of the following decisions made during the risk assessment process, which one is made at the account balance, transaction class, and relevant assertion level?
   a. Materiality for particular items of lesser amounts.
   b. Overall audit strategy.
   c. Tolerable misstatement.
   d. Do not select this answer choice.

10. When performing general audit planning at the financial statement level, after holding a discussion among the engagement team, what is the next step in the audit process to be performed?
    a. Assess audit risk at the overall financial statement level.
    b. Recognize fraud risk factors, areas where special audit consideration may be necessary, etc.
    c. Complete the overall audit strategy, including overall responses at the financial statement level.
    d. Do not select this answer choice.
11. Which of the following types of risk assessment procedures is not explicitly identified in SAS No. 99, Consideration of Fraud in a Financial Statement Audit, as a source of information that should be considered when identifying risks of material misstatement due to fraud?
   a. Observation and inspection.
   b. Preliminary engagement activities.
   c. Questioning of plan management and others.
   d. The engagement team discussing the risk assessment.

12. The nature of the auditor’s procedures always include inquiries, observation, and inspection. Which of the following statements is accurate regarding the extent of risk assessment procedures in continuing engagements versus initial engagements?
   a. The extent of risk assessment procedures in continuing engagements will always be considerably more than in initial engagements.
   b. The extent of risk assessment procedures in continuing engagements will always be the same as in initial engagements.
   c. Subsequent audits will often include less risk assessment procedures than performed in an initial audit.
   d. Do not select this answer choice.

13. Discussions regarding potential material misstatements from error and fraud should include a number of issues. Which of the following does not accurately represent the issues that should be discussed by the engagement team?
   a. Critical issues and areas of significant audit risk.
   b. Which areas are vulnerable to plan management override of controls.
   c. All accounting policies used by the plan.
   d. The degree that materiality will factor into the extent of testing.

14. It is recommended that members of the audit team address the susceptibility of the plan’s financial statements to material misstatements:
   a. At the outset of the audit.
   b. In a specific discussion of fraud risk during the audit.
   c. Throughout the audit.
   d. After completing the audit.
Lesson 2: Understanding the Plan and Its Environment, Including Internal Control

INTRODUCTION

The second standard of field work requires an understanding of the plan and its environment, including its internal control (AU 150.02). Requiring an understanding of the plan and its environment focuses the auditor’s attention on the fact that the understanding establishes a frame of reference within which the auditor assesses the risks of material misstatement and plans the audit in response to those risks. The auditor’s focus in obtaining the required level of understanding should be on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. However, the understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the plan.

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize the types of employee benefit plans that may be encountered in practice.
- Identify the components of internal control and their impact.

Obtaining a solid in-depth understanding of the plan and how it operates is fundamental to both audit efficiency and effectiveness. This understanding is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. It includes not only understanding the risks the client faces in operating, but ideally, understanding what plan management’s response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains. The auditor’s process in obtaining this understanding should be focused on those matters that could cause material misstatements in the financial statements, including potential fraud risk factors, undisclosed related-party or party-in-interest transactions, illegal acts, uncertainties, or going-concern problems.

The auditor’s understanding of the plan also assists in:
- Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit.
- Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make sense and indicate possible risk considerations.
- Considering fraud risk factors, for example, the existence of significant or complex related-party or party-in-interest transactions. Knowledge of key personnel might help the auditor identify employees who could provide relevant information in response to fraud risk inquiries.
- Evaluating the appropriateness and sufficiency of audit evidence.

The audit personnel working on the engagement must understand the plan and its environment sufficiently to effectively analyze the risks and plan and perform an efficient and effective audit in response to those risks. The level of understanding that is attainable by individual members of the audit team will vary with the experience, training, and assigned engagement duties of the personnel, but the partner and manager should spend sufficient time in audit team meetings or on-the-job supervision to convey to the assigned staff the insight needed for effective performance of the audit.

The process of understanding the plan and its environment is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. Also, important new developments with the client and within the employee benefit plan industry often occur every year. For this reason, it is advisable for each member of the audit team to continually try to improve
client and industry knowledge by such measures as reading industry publications, taking self-study courses, and above all, talking to client personnel, including personnel outside the accounting department.

In a continuing engagement, the auditor should update knowledge of the plan and its environment focusing on identifying changes from the prior year in internal or external conditions that might be of audit significance and affect the plan’s business risk or the auditor’s assessment of audit risk.

Components of the Understanding

The auditors’ understanding of the plan and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.
b. Nature of the plan.
c. Objectives, strategies, and related business risks.
e. Internal control.

As part of understanding the plan and its environment, the auditor obtains an understanding of the plan’s selection and application of accounting policies. The selection and application of accounting policies is an integral part of the control environment component of internal control, but merits separate and focused attention because of its significance to the auditor’s assessment of the risks of material misstatement. Similarly, the consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the plan and its environment, it merits separate and focused attention.

Documentation. SAS No. 109 (AU 314.122) indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the plan and its environment to assess the risks of material misstatement in the financial statements.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

SAS No. 99 (AU 316) requires auditors to document their consideration of fraud risk factors.

The following paragraphs provide a detailed discussion of each of the aspects of the plan and its environment that the auditor is required to understand, procedures the auditor may perform to gain that understanding, and the types of risks the auditor may identify throughout that process.

The Plan and Industry, Regulatory, and Other External Factors

The auditor should obtain an understanding of the plan and industry, regulatory, and other external factors relevant to the audit. The objective of the auditor’s understanding is to evaluate whether the plan is subject to specific risks of material misstatement arising from the nature of the plan, the industry, the degree of regulation, or other external forces, such as political, economic, social, or technological. In addition to the matters discussed in the following paragraphs, the auditor should incorporate the information on the scope of the audit obtained in performing preliminary engagement activities.

The Current Economic Crisis. The United States economy is presently experiencing severe instability. That instability may have a significant impact on employee benefit plans and the sponsors of those plans. Accordingly, auditors should consider the risks caused by the current economic crisis when planning and performing an audit of an employee benefit plan. The AICPA Audit Risk Alert, Employee Benefit Plans Industry Developments—2009, contains a discussion of the current economic crisis and its impact on employee benefit plans.
The Audit Risk Alert indicates auditors should understand the economic conditions impacting the industry in which a plan sponsor operates and the effect of those conditions on an employee benefit plan. While that is not a new requirement, recent economic conditions and regulatory actions in response to those conditions may present additional risk factors or may increase the effect of such factors on an audit of an employee benefit plan. Additionally, the Audit Risk Alert highlights the constantly changing nature of economic conditions and suggests auditors consider refining audit procedures to ensure that risks are properly addressed.

The current economic instability may create additional audit risks relating to a plan or a plan sponsor’s ability to continue as a going concern, the valuation of investments, and opportunities and incentives to commit fraud.

AEBP, Paragraph 5.21, points out that “the nature, timing, and extent of planning will vary according to the type of employee benefit plan, size and complexity of the plan’s operations the auditor’s experience with the plan and understanding of the plan and its environment, including its internal control (and any restrictions placed on the audit . . . ).” To understand the significance of these matters, the auditor needs a sufficient understanding of the regulatory and economic environment of employee benefit plans.

The auditor needs some familiarity with ERISA, applicable sections of the IRC, and related DOL and IRS regulations and the potential effect on the plan before proposing for an ERISA audit and in deciding whether the firm can meet the requirements of such an audit before accepting the engagement. To plan the audit, the auditor needs to become more familiar with the complex legal requirements that affect plan structure and operations, financial accounting and reporting, and the related requirements concerning parties in interest and prohibited transactions.

**Inquiry of Plan Management.** The auditor should inquire about the plan’s key personnel, advisors, etc., and the nature, location, and safekeeping arrangements of its assets. The auditor should identify the plan administrator and principal members of management, actuaries, investment advisors, members of the administrative committee or board of trustees, service organizations, and all known related parties and parties in interest. AEBP, Paragraph 5.58b, suggests that the auditor consider inquiring of plan management about whether:

- The plan’s financial statements will be prepared in conformity with generally accepted accounting principles or with another basis of accounting permitted by ERISA or DOL regulations.
- Investment assets are held by outside custodians. If investment assets are held by outside custodians, the auditor may determine the location of investments, the nature of safekeeping arrangements, and the nature and type of investments and whether there are any unusual or hard to value investments or any changes in the types of investments or investment arrangements.
- The plan’s accounting records and participant data are maintained by the plan sponsor, by a bank, by an insurance carrier, or by other outside parties; and how they are maintained.
- Periodic financial statements are prepared.
- The plan maintains a list of *parties in interest*, as defined by ERISA [Title I] Section 3(14).
- The plan has procedures for identifying reportable transactions as defined by ERISA and applicable DOL regulations.
- The plan maintains a list of entities whose employees are participants in the plan.
- The plan has either an audit committee or a group equivalent to an audit committee that has been formally designated with responsibility for oversight of the financial reporting process.
- There is a present intention to terminate the plan or merge or transfer assets in or out of the plan.
- They have knowledge of fraud or suspected fraud affecting the plan involving, (a) management, (b) employees who have significant roles in internal control, or (c) others where the fraud could have a material effect on the financial statements.
• They acknowledge their responsibilities for the design and implementation of programs and controls to prevent and detect fraud.

• They have knowledge of any allegations of fraud or suspected fraud affecting the plan received in communications from employees, former employees, participants, trustees, custodians, regulators, beneficiaries, service providers, third-party administrators, or others.

• The frequency at which transactions are processed and the frequency at which they are valued are the same (daily, for example).

• The plan allows participants to initiate transactions by telephone or in an electronic means (such as the Internet or intranet).

• There were any significant amendments or changes to the plan operations during the year or subsequent to year-end.

• They acknowledge their responsibilities for unrecorded adjustments.

• There have been any changes in service providers.

• There have been significant changes in the number of participants.

As indicated above, the auditor may inquire about the nature of the plan’s investment assets and, if investment assets are held by outside custodians, identify the location of the assets and the nature of the safekeeping arrangements. Are the investments held in the name of the plan? Is the custodian in possession of the investments or does the custodian use another entity’s facilities? What investigation has the plan administrator made of the custodian’s reputation and financial capability? Is the custodian independent or is it related to the plan or sponsor?

**Review of Plan Documents.** AEBP, Paragraph 5.58, identifies the following procedures involving plan documents that the auditor may consider applying to plan the audit and obtain an understanding of the plan and its environment:

• Read the plan instrument, including amendments, to determine, among other things, whether the plan is (a) a single employer, multiemployer, or multiple employer plan, (b) a contributory or noncontributory plan, (c) required to be funded or not, and (d) the nature of benefits promised.

• Read agreements with trustees, investment advisers, and insurance companies to determine whether the plan is a self-funded, insured, or split-funded plan. If the plan is an insured or split-funded plan, determine the type of insurance contract (for example, deposit administration, immediate participation guarantee, or individual policy).

• Review the prior-year financial statements and Form 5500, filings with the DOL and related correspondence, and the status of IRS determination letters and DOL advisory or exemption opinions, if any. Consider the tax-exempt status of the plan, including whether the plan has procedures for assuring compliance with applicable IRC plan qualification requirements.

• Read reports from the plan’s actuary, bank or trustee, insurance company, service auditors, other independent auditors, and internal auditors. After reading these reports, communications may be necessary with the preparer of these reports to determine the extent of audit procedures or the ability to rely on the content of any of these reports.

• Read minutes of trustee, benefits committee, or board of directors meetings applicable to the plan.

This information is necessary for understanding the plan’s organization and operations and is useful in considering audit risk (for example, there is usually a greater risk of material misstatement of contributions for a multiemployer plan).
Pending Amendments. In obtaining an understanding of plan operations, the auditor should be aware that a plan may appropriately operate differently than the plan instrument indicates. The auditor should ask the plan administrator about pending amendments that have already been incorporated in plan operations but which, as of yet, have not been included in a plan amendment. Generally, the auditor should request a formal resolution that reflects the plan sponsor’s intent to make the amendments and that describes the required plan amendments. The auditor can then plan audit procedures to test whether plan transactions are executed in accordance with the pending amendments rather than the provisions of the plan instrument.

Plan Defects. The auditor may discover defects in the plan while reviewing the plan documents or performing engagement acceptance or planning procedures. Plan defects include the following:

- Form defects, which occur when the plan’s provisions do not satisfy the qualification requirements of the IRC.
- Operational defects, which occur when the plan fails to operate in accordance with the plan provisions.
- Demographic defects, which occur when the plan fails to satisfy the nondiscrimination requirements of the IRC due to a shift in the demographics of the employer’s workforce.

If the auditor discovers operational defects in the plan, he or she should notify the plan administrator and provide assistance as necessary. The auditor should consider discussing the IRS’s Employee Plans Compliance Resolution System with the plan administrator.

Review of Financial Statements and Form 5500. The auditor’s review of plan documents may include review of prior years’ financial statements and Forms 5500 filed. This review is useful in obtaining an understanding of recent operations and identifying matters of audit significance. For example, the Form 5500 requires reporting of loans or leases in default or considered uncollectible in Schedule G filed with the Form. Such information would be relevant in auditing the allowance for uncollectible accounts. The auditor should identify significant financial statement areas, the names of parties in interest, and prior problem areas.

The Health Insurance Portability and Accountability Act (HIPAA) affects all health care providers and other entities that manage or have access to health or medical records, referred to as “covered entities.” HIPAA contains an “Administrative Simplification” provision that essentially acts as a federal medical records privacy and security law and governs the storage, use, release, and transmission of confidential patient health information. One of the sets of regulations under HIPAA, known as the “Privacy Rule,” addresses the privacy of medical information. Employer-administered health plans with less than 50 participants are not subject to the HIPAA privacy rules. Additional information is available on the U.S. Department of Health and Human Services website at www.hhs.gov/ocr/hipaa.

The Privacy Rule requires covered entities to obtain assurances from their business associates that the business associate will appropriately safeguard the health information they receive. A business associate is a person or entity that performs certain functions or activities that involve the use or disclosure of protected health information. For example, a TPA that processes claims is a common business associate of health plans. Additionally, a CPA firm auditing a health plan will generally be considered a business associate of the plan because of the needed access to claim information.

HIPAA requires any covered entity doing business with a business associate to have a contract with the business associate before it can disclose any protected health information. The contract must be in writing and include certain specific protections for the information. AEBP Paragraph 5.61, states after an auditor has entered into a business associates agreement, the auditor would be permitted access to the information necessary to issue an opinion on the plan’s financial statements.

In addition to signing business associate agreements, some TPAs or health plans may ask auditors to sign confidentiality or indemnification agreements before granting access to claims records. Auditors should carefully read and review any similar type of agreement before signing because some agreements may include statements that contradict the arrangements between the plan and the auditor covered in the engagement letter. For example, a statement may be included whereby the auditor would indemnify the TPA or plan for any errors detected during
testing. Thus, because of the potential for legal issues, the auditor should also consider having his or her legal counsel review the agreement before signing. If the auditor and TPA are unable to agree on the language in the confidentiality agreement, the TPA could refuse access to necessary information, thereby creating a scope limitation for the auditor.

Auditors of health plans covered by HIPAA should consider the following issues when planning their audits:

- The impact of the plan’s or the TPA’s privacy measures on the auditor’s access to the plan’s records.
- If the plan or the TPA will require the auditor to sign a business associate agreement or confidentiality agreement.
- The extent of details of the protected health information examined during testing that should be documented.

Because the auditor’s workpapers may be subject to review by peer reviewers, the Department of Labor, and other regulatory bodies, the auditor should specifically consider the extent of documentation necessary when performing audit procedures related to protected health information. According to AEBP, Paragraph 5.61, HIPAA regulations permit the auditor’s workpapers to contain protected health information. However, by including protected health information in the workpapers, the auditor’s firm is required to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of that information. Accordingly, the audit firm should:

- Restrict access to the workpapers.
- Provide an accounting of disclosures of protected health information.
- Report any misuse of protected health information by the audit firm to the sponsor.

The auditor should avoid including information in the workpapers that may identify an individual participant or a participant’s protected health information. The Employee Benefit Plans Industry Developments—2009 (Audit Risk Alert), Appendix C, explains that de-identified health information is not subject to HIPAA and that to be de-identified the information in workpapers may not contain: (a) names, (b) dates (such as birth date, admission date, discharge date, and date of death), (c) age if 90 or over, (d) complete social security numbers (or block out all except last four digits), (e) telephone and fax numbers, (f) email addresses, (g) medical record numbers, (h) health plan beneficiary numbers, or (i) account numbers.

Objectives, Strategies, and Related Business Risks

The auditor should obtain an understanding of the plan’s objectives, strategies, and related business risks. The basic concept here is that most business risks eventually have financial consequences and, thus, an effect on the financial statements. Not all business risks create risks of material misstatement, so the auditor needs to focus on those risks that have financial reporting implications in the plan’s particular circumstances. For example, a plan’s investment strategies usually would have financial statements implications.

The auditor obtains an understanding of plan management’s objectives and strategies to identify the related business risks. Plan management determines the plan’s objectives. Plan management’s strategies are the operational approaches adopted to achieve the objectives. The related business risks are the significant conditions, events, circumstances, actions, or inactions that could adversely affect the plan’s ability to achieve its objectives or implement its strategies.

When obtaining an understanding of plan management’s objectives and strategies to identify the related business risks, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the plan. Smaller employee benefit plans generally do not have formal plans or processes that are documented, which forces the auditor to rely primarily on inquiries. When making inquiries, the auditor will generally restrict questioning to upper management of the plan given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt plan management to describe the plan’s future trends, expectations, objectives, and strategies.
Measurement and Review of the Plan’s Financial Performance

The auditor should obtain an understanding of the measurement and review of the plan’s financial performance made by plan management and external parties. Information used for measurement and review might include the following:

a. Key performance indicators (KPI), both financial and nonfinancial (e.g., investment returns or employee participation rates).

b. Trends.

c. Key ratios and other operating and financial statistics.

d. Forecasts, budgets, and variance analyses.

e. Period-on-period financial performance.

f. Comparisons to performance of comparable plans or investments (i.e., benchmarking).

Information prepared by external parties might include analyst reports and investment company reports.

Performance measures can affect the audit and the auditor’s assessment of the risks of material misstatement in several ways, including the following:

a. The pressure to meet performance targets could motivate plan management actions, including intentional misstatements, and, thus, affect the auditor’s risk assessment.

b. Use of performance measures might highlight unexpected results or trends such as unusually high benefit payments, which upon investigation result in detection of misstatements.

c. The auditor might be able to use key performance indicators or other measures used by plan management when performing analytical procedures. However, the auditor should consider whether the information used by plan management is reliable and provides the degree of precision that is needed for the analytical procedures.

A small plan might not have a formal process to measure and review financial performance, but plan management will still likely be aware of key performance indicators that it uses and that can be helpful to the auditor.

Selection and Application of Accounting Policies

The auditor should obtain an understanding of plan management’s selection and application of accounting policies and evaluate whether the policies are appropriate for the plan and consistent with policies used in the employee benefit plan industry. This understanding is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels, including both misstatements due to fraud and those due to error. The auditor’s assessment of the appropriateness of the accounting policies that plan management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements and, hence, in assessing risks of material misstatement. For an employee benefit plan, significant accounting policies are those for actuarial valuations and investment valuations.

The auditor’s understanding of plan management’s selection and application of accounting policies includes the following:

a. Relevant accounting standards and industry specific practices.

b. The methods the plan uses to account for significant and unusual transactions.

c. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
d. Changes in the plan’s policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP (or an OCBOA).

e. Financial reporting standards and regulations that are new to the plan and management’s plans to adopt such requirements, including new accounting standards.

f. The process used by plan management in formulating particularly sensitive accounting estimates.

g. The methods used to identify matters for disclosure and how the plan achieves clarity in disclosure.

The auditor uses the understanding of these aspects of plan management’s selection and application of accounting policies to identify audit areas of higher risk and to identify what could go wrong at the relevant assertion level. For example, if the plan has to measure fair value for hard-to-value investments, there ordinarily is a higher risk of material misstatement for the valuation of those assets. For items of disclosure, many auditors of smaller plans assist plan management in preparing the financial statements. In those cases, identification and clarity of required disclosures are often heavily influenced by the auditor. Therefore, the potential for risk may be mitigated with respect to disclosure.

The auditor should use the understanding of plan management’s selection and application of accounting policies along with the identification of fraud risk factors to evaluate whether an overall response is necessary. In establishing the overall audit strategy, the auditor focuses on whether the accounting principles selected and policies adopted are being applied in an inappropriate manner. If the auditor identifies a risk in this area, it is often addressed by an overall response, such as the assignment of more experienced personnel and a higher level of supervision, as well as by the selection of specific further audit procedures.

The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as:

- The auditor’s knowledge and experience with the employee benefit plan industry.
- The auditor’s past experience with the client.
- The degree of financial reporting sophistication of the client.
- The extent of new accounting standards that are recently effective for the client.
- The auditor’s participation in assisting the client with the selection of accounting policies and the preparation of the financial statements.

For many small employee benefit plan clients, the auditor is instrumental in both selecting accounting principles and choosing the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process since the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application. For other situations where the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may inquire about the matters discussed above. Also, the auditor may supplement inquiries with a review of prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to the employee benefit plan industry or the plan’s transactions.

**Fraud Risk Factors**

When obtaining information about the plan and its environment, the auditor should consider whether the information indicates that fraud risk factors are present. That is, the auditor considers the existence of fraud risk factors while performing other audit planning procedures. Auditors are not specifically required to look for fraud risk factors during planning, but are required to consider, based on their knowledge of the plan and its environment, whether fraud risk factors exist. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action.
The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the plan and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor’s primary concern in considering fraud risk factors is to identify whether a risk factor is present and should be considered in identifying and assessing risks of material misstatement due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of professional judgment.

**Examples of Fraud Risk Factors.** SAS No. 99 (AU 316) and Appendix H of AEBP provide examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors presented in SAS No. 99 and Appendix H of AEBP are classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the standard and Appendix H of AEBP further classify the illustrative risk factors into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed. In fact, SAS No. 99 (AU 316.33) states:

> Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances.

Auditors should not consider significance or mitigating controls when evaluating whether a fraud risk factor is present. Those matters are considered later. Auditors should consider the importance of the modifying language in the risk factors (such as inappropriate means, unduly aggressive, etc.). Many employee benefit plans lack appropriate segregation of duties. The primary consideration, however, is whether the lack of appropriate segregation of duties is not mitigated by other factors. If the mitigating factors appear to adequately address the limited segregation of duties, the auditor would likely not consider this to be a fraud risk factor.

For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration should be given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. One of the primary fraud risks in employee benefit plans is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. Therefore, there should always be some consideration of fraud risk factors related to misappropriation. In addition, when considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. The auditor, during the course of the audit, may become aware of information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation. Examples include:

- Anticipated layoffs at the plan sponsor that are known to employees of the plan or plan sponsor.
- Unfavorable changes in employee compensation or benefit plans at the plan sponsor.
- Failure to receive promotions or other expected rewards.
- Known unusual changes in behavior or lifestyle.
- Employees of the plan or plan sponsor that are known to be experiencing significant personal financial obligations.
• Behavior indicating dissatisfaction with the plan sponsor, including disregard for the plan or the plan sponsor’s policies and procedures.

If the auditor becomes aware of the presence of these or similar risk factors, he or she should consider them when identifying the risks of material misstatement due to fraud.

If fraud risk factors are present, SAS No. 109 (AU 314.12) requires that “the auditor should consider whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transaction, or disclosures at the relevant assertion level, or both.” An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. The auditor’s understanding of the plan and its environment results from an understanding of all the following items except:
   a. Regulatory factors.
   b. Basic auditing procedures.
   c. Objectives and strategies.
   d. Review of the plan’s financial performance.

16. Plan defects the auditor may discover while reviewing the plan documents or performing engagement acceptance or planning procedures include all of the following except:
   a. Confidentiality defects.
   b. Form defects.
   c. Operational defects.
   d. Demographic defects.

17. Which of the following statements regarding employee benefit plans is inaccurate?
   a. The auditor should obtain an understanding of the plan’s objectives.
   b. Most business risks eventually have financial consequences.
   c. All business risks create risks of material misstatement.
   d. The auditor obtains an understanding of plan management’s objectives and strategies.

18. Of the following statements, which one is not part of the auditor’s understanding of plan management’s selection and application of accounting policies?
   a. Relevant accounting pronouncements.
   b. The methods the plan uses to account for significant transactions.
   c. The methods used to identify matters for disclosure.
   d. Plan management’s process for formulating all accounting estimates.

19. Which of the following statements is accurate regarding fraud risk factors?
   a. The auditor does not need to determine whether fraud risk factors are present when performing other audit planning procedures.
   b. Auditors are required to look for fraud risk factors during audit planning.
   c. Fraud risk factors are conditions or events that indicate attitudes/rationalizations to justify a fraudulent action.
   d. Fraud risk factors are normally inconsequential in identifying the risks of material misstatement at the financial statement and relevant assertion levels.
20. Which of the following would not be considered one of the risk factors that could lead to material misstatement due to fraud?

a. Unfavorable changes in employee compensation.

b. Failure to receive promotions or other expected rewards.

c. Known unusual changes in behavior.

d. An employee’s plan to retire during the audit period.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

15. The auditor’s understanding of the plan and its environment results from an understanding of all the following items except: (Page 54)

a. Regulatory factors. [This answer is incorrect. The auditor’s understanding of the plan and its environment includes an understanding of industry, regulatory, and other external factors. This helps the auditor obtain an understanding of the plan’s selection and application of accounting policies.]

b. Basic auditing procedures. [This answer is correct. Understanding of basic auditing procedures will not enhance the auditors’ understanding of the plan and its environment since it is not related to the specific plan the auditor is engaged to audit.]

c. Objectives and strategies. [This answer is incorrect. Objectives, strategies, and related business risks are among the items which, if understood by the auditor, will aid in his or her understanding of the plan and its environment since it provides further understanding of the client’s benefit plan.]

d. Review of the plan’s financial performance. [This answer is incorrect. The auditor’s understanding of the plan and its environment includes information obtained by measurement and review of the plan’s financial performance. This information will help develop expectations of the results of analytical procedures.]

16. Plan defects the auditor may discover while reviewing the plan documents or performing engagement acceptance or planning procedures include all of the following except: (Page 57)

a. Confidentiality defects. [This answer is correct. Confidentiality defects are not one of the plan defects the auditor may discover in the plan while reviewing the plan documents or performing engagement acceptance or planning procedures. A confidentiality defect might be discovered when reviewing a health plan’s compliance with HIPAA.]

b. Form defects. [This answer is incorrect. Form defects are one of the plan defects the auditor may discover in the plan. Form defects occur when the plan’s provisions do not satisfy the qualification requirements of the IRC.]

c. Operational defects. [This answer is incorrect. Operational defects are another of the plan defects the auditor may discover in the plan. Operational defects occur when the plan fails to operate in accordance with the plan provisions, as detailed in the plan document.]

d. Demographic defects. [This answer is incorrect. Demographic defects are another of the plan defects the auditor may discover in the plan while reviewing the plan documents or performing engagement acceptance or planning procedures. Demographic defects occur when the plan fails to satisfy the nondiscrimination requirements of the IRC due to a shift in the demographics of the employer’s workforce.]

17. Which of the following statements regarding employee benefit plans is inaccurate? (Page 58)

a. The auditor should obtain an understanding of the plan’s objectives. [This answer is incorrect. The auditor should obtain an understanding of the plan’s objectives, strategies, and related business risks. This understanding will further the auditor’s knowledge of the plan and aid in identifying risks within the plan.]

b. Most business risks eventually have financial consequences. [This answer is incorrect. Most business risks eventually have financial consequences and, thus, an effect on the financial statements. This effect on the financial statements will affect the planned audit procedures.]

c. All business risks create risks of material misstatement. [This answer is correct. Not all business risks create risks of material misstatement, so the auditor needs to focus on those risks that have financial reporting implications in the plan’s particular circumstances.]
d. The auditor obtains an understanding of plan management’s objectives and strategies. [This answer is incorrect. The auditor obtains an understanding of plan management’s objectives and strategies in order to identify the related business risks.]

18. Of the following statements, which one is not part of the auditor’s understanding of plan management’s selection and application of accounting policies? (Page 59)

a. Relevant accounting pronouncements. [This answer is incorrect. The auditors’ understanding of plan management’s selection and application of accounting policies includes relevant accounting pronouncements and industry specific practices. The auditor uses this information to identify audit areas of high risk.]

b. The methods the plan uses to account for significant transactions. [This answer is incorrect. The methods the plan uses to account for significant and unusual transactions are included in the auditor’s understanding of plan management’s selection and application of accounting policies. One reason the auditor would need this information is to identify what could go wrong at the relevant assertion level.]

c. The methods used to identify matters for disclosure. [This answer is incorrect. The methods used to identify matters for disclosure and how the plan achieves clarity in disclosure are included in the auditor’s understanding of plan management’s selection and application of accounting policies so that the auditor can better plan an effective audit of the benefit plan.]

d. Plan management’s process for formulating all accounting estimates. [This answer is correct. One area included in the auditor’s understanding of plan management’s selection and application of accounting policies is the process used by plan management in formulating particularly sensitive accounting estimates, but not all accounting estimates. This could be beyond the scope of the audit.]

19. Which of the following statements is accurate regarding fraud risk factors? (Page 60)

a. The auditor does not need to determine whether fraud risk factors are present when performing other audit planning procedures. [This answer is incorrect. The auditor should consider whether the information indicates that fraud risk factors are present when obtaining information about the plan and its environment so that if fraud does exist, it has a chance of being identified.]

b. Auditors are required to look for fraud risk factors during audit planning. [This answer is incorrect. Auditors are not specifically required to look for fraud risk factors during planning, but are required to consider whether fraud risk factors exist based on their knowledge of the plan and its environment.]

c. Fraud risk factors are conditions or events that indicate attitudes/rationalizations to justify a fraudulent action. [This answer is correct. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action.]

d. Fraud risk factors are normally inconsequential in identifying the risks of material misstatement at the financial statement and relevant assertion levels. [This answer is incorrect. Fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor’s primary concern in considering fraud risk factors is to identify whether a risk factor is present and should be considered in identifying and assessing risks of material misstatement due to fraud.]

20. Which of the following would not be considered one of the risk factors that could lead to material misstatement due to fraud? (Page 61)

a. Unfavorable changes in employee compensation. [This answer is incorrect. Unfavorable changes in employee compensation or benefit plans at the plan sponsor indicates a risk for material misstatement due to fraud since it can indicate potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation.]
b. Failure to receive promotions or other expected rewards. [This answer is incorrect. Failure to receive promotions or other expected rewards, such as a bonus, could pose a risk for material misstatement due to fraud. When employees fail to receive what they feel they are due and the employees have access to assets that are susceptible to misappropriation, it can put the assets in danger of fraud.]

c. Known unusual changes in behavior. [This answer is incorrect. An employee that has been observed as having unusual changes in behavior or lifestyle could indicate a potential risk for material misstatement due to fraud. The unusual behavior can be a tip-off for the auditor to investigate for fraud.]

d. An employee’s plan to retire during the audit period. [This answer is correct. A normal occurrence, such as retirement, would not normally be a cause for concern as a risk for material misstatement due to fraud.]
THE UNDERSTANDING OF INTERNAL CONTROL

SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides guidance to auditors related to consideration of internal control as part of an audit. It also provides guidance about how the plan’s use of information technology (IT) affects the auditor’s consideration of internal control in planning the audit.

Components of Internal Control

SAS No. 109 (AU 314.40) requires auditors to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. SAS No. 109 requires an understanding of the five interrelated components of internal control defined and described in COSO’s *Internal Control—Integrated Framework*. Those components are as follows:

- a. Control environment
- b. Risk assessment
- c. Information and communication
- d. Monitoring
- e. Control activities

Each of these components is discussed further in the following paragraphs.

In assessing the risk of material misstatement of the financial statements to develop an overall audit strategy, auditors generally focus on obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components, typically obtaining an understanding of the control environment first. The understanding of control activities is not needed until planning the nature, timing, and extent of further audit procedures at the assertion level. As a practical matter, however, auditors often obtain an understanding of control activities while obtaining an understanding of the other control components. As a plan’s operations and systems become more complex, auditors will most likely need to increase their understanding of the internal control components to obtain the understanding necessary to assess the risk of material misstatement of the financial statements and to plan the nature, timing, and extent of further audit procedures.

Throughout this discussion, the internal control components of control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring are referred to as “entity-level” controls. These controls typically have a persuasive effect on the plan’s system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. The IT environment and general computer controls also have a pervasive effect and are considered at the entity level. The financial reporting system (along with the IT environment and general computer controls) and the control activities component of internal control are referred to as “activity-level” controls.

Nature of the Auditor’s Understanding

SAS No. 109 (AU 314) requires auditors to obtain a sufficient understanding of the five components of internal control to assess risk and design the nature, timing, and extent of further audit procedures. To obtain that understanding, the SAS requires auditors to perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. A key consideration is whether and how the plan’s internal control prevents, or detects and corrects, material misstatements in relevant assertions related to transactions, account balances, or disclosures.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. In other words, the auditor considers the
effectiveness of the control in achieving its objective. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to management and those charged with governance.

The documentation of a control procedure, however, does not demonstrate that the control is actually being used. The auditor, therefore, should also determine if the control, as documented or described, actually exists and the plan is using it. In other words, the auditor should use risk assessment procedures to obtain audit evidence that the control has been implemented. Generally, the auditor uses procedures such as observation or inspection, combined with inquiries, to verify implementation. Inquiry alone is not sufficient to evaluate the design of a control and determine if it has been implemented.

Normally, the auditor’s understanding of internal control design and implementation is not sufficient to serve as testing the operating effectiveness of controls. The same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) are also used when testing controls for operating effectiveness. However, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor’s procedures may serve both purposes. For example, a walkthrough can serve as a test of operating effectiveness and in some cases, along with other procedures that test operating effectiveness, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor’s assessment and testing of the related general controls.

**Extent of the Auditor’s Understanding**

The overriding requirement regarding the understanding of internal control is that it should be sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement requires the auditor to develop a fairly thorough and robust knowledge of the components of internal control, primarily because the auditor is required to have, and document, the basis for his or her risk assessment. The auditor is not permitted to simply default to high control risk. In most situations, the auditor’s understanding of internal control will be more time consuming and comprehensive than that required for the understanding of the other elements of the plan and its environment. In addition, for initial audit engagements, the effort and time to gather information on the components of internal control that is sufficient to assess risk will most likely exceed that necessary for engagements in following years.

**Determining the Extent of the Understanding.** While the professional standards indicate that the understanding should include the five components noted above and a variety of other matters that are discussed throughout this course, auditors will often struggle over what controls or combinations of controls to assess. SAS No. 109 (AU 314.48) clearly notes that this is a matter of professional judgment.

The auditor should remember that it is not necessary to obtain an understanding of every control at the client. To do so would be cost prohibitive and simply unnecessary for most audit engagements. Rather, the auditor’s focus should be on those key controls that are relevant to the audit. The auditor should make an informed judgment as to the controls or combination of controls to assess. In general terms, the extent of the understanding, along with the nature, timing, and extent of the risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor’s prior experience with the client.
- Materiality and tolerable misstatement.
- Size of the plan.
- Type of plan.
• Degree of diversity of systems within the plan or plan sponsor, including the use of service organizations.

• Number of participants and/or employers.

• Applicable legal and regulatory requirements.

• Financial sophistication of the client.

The auditor’s understanding of the plan and its environment other than internal control generally influence the extent of the understanding of internal control components. Most of the factors noted above are determined to a major degree when the auditor performs risk assessment procedures to understand the plan and its environment. Furthermore, that understanding will often result in the identification of risks of material misstatement that will further shape the direction, extent, and depth of the auditor’s understanding of internal control. (However, the auditor should be aware that additional risks of material misstatement may be identified when obtaining an understanding of internal control and by performing further audit procedures.) It is recommended that the auditor perform risk assessment procedures related to the understanding of the plan and its environment discussed above prior to obtaining an understanding of internal control.

Using the Results of the Understanding of Internal Control

The understanding of internal control should be sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

• Identify types of potential misstatements.

• Consider factors that affect the risks of material misstatement.

• Design tests of controls, when applicable, and substantive procedures.

In addition, the auditor should be alert for risks that may be identified during the process of obtaining an understanding of internal controls.

Effect of Information Technology (IT) on Internal Control

Many small employee benefit plans have simple computer operations or engage an EDP service center to process transactions. However, some employee benefit plans, or their third-party administrators, may have internal control that is heavily dependent on information technology. SAS No. 109 does not address IT as a separate component of internal control—it discusses how IT fits into internal control. While the SAS does not require that auditors take a different approach in considering internal control when a plan uses IT, it indicates that auditors should consider how IT affects a plan’s internal controls because IT affects the way transactions are initiated, authorized, recorded, processed, and reported. The effect on the client’s internal control is related more to the nature and complexity of the system than to the client’s size. Use of the Internet or any other information technology does not necessarily mean that a plan’s internal control is heavily dependent on IT.

Benefits and Risks of IT. The use of computers may enhance the effectiveness and efficiency of the plan’s internal control because of the consistency, timeliness, and accuracy inherent in automated systems. Use of computers also offers benefits in terms of data analysis, monitoring the plan’s performance, reduced risk of override, and systems and data security. For example, in a computerized system, security controls can help achieve segregation of duties. However, the use of computers also poses certain risks to a plan’s internal control, such as:

• Reliance on systems or programs that are inaccurately processing data or processing inaccurate data.

• Unauthorized access to data that may result in destruction of data or improper changes to data.

• Unauthorized changes to master file data.

• Unauthorized changes to systems or programs.
• Failure to change systems or programs when necessary.
• Inappropriate manual intervention.
• Loss or inability to access data.

The extent and nature of those risks depends on the nature and characteristics of the plan’s system. In many systems, users can access a common database of information that affects financial reporting. A lack of control at a single user entry point could compromise the security of the database and result in improper changes to or destruction of data.

In many IT environments, the processing of information is often decentralized. For example, in a “server-client” arrangement, a central server hosts various clients and processing occurs both centrally on the server and remotely by various clients. As a result, the IT environment is much more open as compared to the days when all IT processing was confined to a mainframe computer. These environments can present a higher element of risk given a wider range of access to data and processing by a variety of users. Threats to data and financial reporting may range from unauthorized access to data and processing to the introduction of computer viruses.

In today’s IT computing environments, the processing of financial data often is not confined within formally developed or vendor supplied software applications. In many cases, users may access a database warehouse and import data into a spreadsheet program for processing outside of a “formal” application. Among other things, the output of the spreadsheet application might be used as data inputs into a standard software application, support for journal entries, or support for disclosure information. However, in many cases, unlike the controls over the development or integration of standard software applications, spreadsheet applications developed by users might not be subject to any formalized controls. For example, spreadsheet results may not be subjected to formalized testing or there may be no controls over access, development, modification, or the use of multiple versions of a spreadsheet application.

SAS No. 109 (AU 314.96) notes that the auditor should consider whether the entity has established effective controls that adequately respond to the risks that arise from IT. Such controls not only include properly designed and implemented application controls, but the general controls upon which application controls depend. The auditor should consider testing general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive tests.

The auditor also should be aware that the use of IT may impact the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of the transaction. For example, in highly automated processing with little or no manual intervention where information is initiated, authorized, recorded, processed, or reported electronically, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors should consider whether specialized IT skills are needed to determine the effect of IT on the audit, understand the IT controls, or to design and perform tests of IT controls or substantive procedures. That determination should be made relatively early in the planning process to assure that the necessary resources are available on a timely basis. The decision to use an IT specialist is a matter of auditor judgment. SAS No. 108 (AU 311.23) states that auditors should consider the following factors in determining whether the audit team should include individuals that possess specialized IT skills:

• The complexity of the plan’s systems and IT controls and the manner in which they are used.
• The significance of changes made to existing systems or the implementation of new systems.
• The extent to which data is shared among systems.
• The plan’s use of emerging technologies.
The significance of audit evidence that is available only in electronic form.

An IT specialist may be either a member of the auditor’s firm or an outside professional.

If the auditor uses an IT specialist on the engagement team, the auditor should be knowledgeable enough to communicate the audit objectives to the specialist, evaluate whether the procedures performed by the specialist meet the auditor’s objectives, and determine the effects of the procedures on the nature, timing, and extent of other planned procedures. That does not mean auditors have to be experts in information technology. The auditor’s responsibility when using a computer specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of computer applications and controls, especially those most relevant to particular client systems. That understanding can be gained from experience with the client or from attending training classes or seminars. The extent of the understanding will vary with the nature of the plan’s IT environment. If the firm uses an outside professional, the guidance in SAS No. 73 (AU 336) should be considered.

Documentation

SAS No. 109 requires documentation of the understanding of the plan and its environment, including internal control. For internal control, the auditor is required to document the understanding obtained for the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

SAS No. 109 permits auditors flexibility in the manner of documentation. The form and extent of documentation is influenced by factors such as the complexity, size, and nature of the plan and the use of technology. Where applicable, some auditors have supplemented their documented understanding with existing documentation of control systems prepared by the plan. Due to the increasing visibility of the importance of controls, many plan and plan sponsors have developed or enhanced their internal documentation and evaluation of internal controls. Auditors may consider inquiring of the client about the existence of such documentation along with any supporting evaluation of the effectiveness of controls. In those cases, the auditor may gain additional audit efficiencies and a better understanding of the plan’s internal control.

Control Environment

The control environment of an employee benefit plan includes the overall attitude, awareness, and actions of the plan administrator and those charged with governance concerning the importance of control and its emphasis in plan operations. AEBP, Paragraph 6.08, states, “In obtaining an understanding of the control environment, the auditor should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance (for example, the plan administrator, the administrative committee or board of trustees, and others) concerning the plan’s internal control and its importance in achieving reliable financial reporting.”

The auditor should inquire about the plan administrator’s controls for identifying parties in interest, communicating rules concerning prohibited transactions to those parties, and detecting noncompliance with prohibited transaction rules. The plan administrator should maintain a list of parties in interest, and the auditor should obtain this list during audit planning and communicate its contents to the audit team. AEBP, Paragraph 11.08, states that “. . . the auditor should be aware of the possible existence of party in interest and material related-party transactions that could affect the financial statements or for which DOL Reporting Regulations . . . and FASB Statement No. 57 (FASB ASC 850) require disclosure.”

In general, the procedures performed to identify and audit parties-in-interest transactions parallel those for related-party transactions. AEBP, Paragraphs 11.09 and 11.10, enumerate the following procedures, among others, that involve inquiring of plan management about parties-in-interest transactions:

- Evaluate the plan administrator’s procedures for identifying and properly accounting and reporting for party-in-interest transactions.
- Request from appropriate personnel the names of all parties in interest and inquire whether there were any transactions with these parties during the period.
• Inquire of the plan administrator whether any prohibited transactions have been identified as a result of past DOL, IRS, or other governmental examinations.

• Provide audit personnel performing segments of the audit with the names of known parties in interest so that they may become aware of transactions with such parties during the audit.

The plan administrator’s attitude, awareness, and actions about these compliance matters as revealed by responses to the auditor’s inquiries shape the auditor’s understanding of the control environment.

AEBP, Paragraph 6.08, states, “The control environment is normally enhanced by the existence of an audit committee; however, many employee benefit plans do not have audit committees and, therefore the auditor may consider whether the plan’s investment or administrative committee has been formally designated with responsibility for oversight of the financial reporting process and, in effect, functions as an audit committee.” The auditor has additional communication responsibilities as established by SAS No. 114 on communication with those charged with governance.

Bonding of employees with financial responsibilities is also generally considered an enhancement of the control environment. ERISA, Title I, Section 412(a), requires bonding of every fiduciary and person who handles plan funds or property. ERISA establishes the amount of the bonding, the type of bond, the type of bonding company that may be used, and exceptions to the bonding requirements. However, the auditor should be aware that the bonding of the plan administrator or administrative committee as fiduciaries does not reduce the auditor’s need to inquire about the integrity and reputation of plan management. A bonding company does not necessarily investigate the background of bonded individuals and the auditor should not assume there has been such an investigation.

All plans should be proactive in reducing fraud opportunities by identifying and measuring fraud risks, taking steps to mitigate identified risks, and implementing and monitoring appropriate preventive and detective controls and other antifraud measures. However, the nature and extent of these risk assessment and monitoring activities should be commensurate with the size and complexity of the plan. It is important for the plan administrator to understand his or her responsibility for establishing and monitoring the plan’s fraud risk assessment process. That process should include a sufficient degree of fraud awareness on the part of the plan administrator, and appropriate fraud risk management activities with oversight from the board of trustees, administrative committee, or those charged with governance. The fraud risk assessment and monitoring process for a typical plan may include:

a. communicating to employees of the plan or plan sponsor the plan administrator’s views on business practices and ethical behavior, either orally or by example,

b. thoroughly investigating any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the plan’s values and expectations through appropriate communication,

c. considering standards of ethical behavior and appropriate business practices in the plan or plan sponsor’s employee training and evaluation procedures,

d. identifying fraud risks and taking appropriate action to reduce or eliminate the risks, and

e. exercising appropriate oversight of the plan’s fraud risk assessment and monitoring activities by the board of trustees, administrative committee, or those charged with governance.

Risk Assessment

Risk assessment for financial reporting purposes refers to the plan’s identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles [or an other comprehensive basis of accounting (OCBOA)]. More simply, it can be described as identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements.

A key step in the risk assessment process is identifying changed conditions (for example, adopting plan amendments, appointing a new trustee, or hiring a new plan administrator) and taking necessary actions. This involves
identifying and communicating both external and internal events or activities that may affect the plan’s financial reporting objectives and analyzing the associated risks. Risks relevant to the financial reporting process may arise due to the following:

- Changes in the plan’s operating environment.
- New personnel.
- New or revised information systems.
- Rapid growth by the plan.
- New technology.
- New activities.
- Restructuring by the plan sponsor.
- New accounting standards or new DOL or IRS regulations.

The earlier those risks can be identified, the more effectively they can be dealt with.

The auditor should gain an understanding of how plan management identifies and takes action to address risks relevant to the plan’s financial reporting objectives. This includes gaining an understanding of how the plan administrator estimates the significance of those risks and assesses the likelihood of their occurrence. For example, if the plan is amended, the auditor should gain an understanding of the plan administrator’s assessment of the impact on internal control and the steps he or she is taking to address that impact. For risks related to fraud, the auditor should gain an understanding of whether the plan has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements) and whether the plan has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risks. Gaining an understanding of plan management’s risk assessment is not a complex process. Normally, the auditor can gain this understanding based on his or her experience with the plan, general observations of its operations, and discussions with the plan administrator.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the plan’s transactions. It also includes the accountability over the plan’s net assets. An information system may be computerized, manual, or a combination of the two depending on the size and complexity of the plan. Communication is the process of providing an understanding of roles and responsibilities to individuals within the plan regarding internal control over financial reporting. Although part of the same internal control component, the financial reporting system and communication process is discussed separately in the following paragraphs.

Auditors are typically very familiar with the process of understanding the financial reporting system. When obtaining an understanding of the plan’s internal control, auditors often spend most of their time in this area since it provides the auditor with other key information needed for the audit. For example, the understanding of the financial reporting system contributes to the auditor’s ability to design and conduct efficient and effective substantive procedures since the auditor gains knowledge of the types, sources, and locations of documents and other evidence along with the individuals who are responsible for processing them. However, auditors should not lose sight of the importance of the communication of accounting and financial reporting roles within the plan. Achievement of the objectives of a well-designed financial reporting system can easily fail if accounting personnel do not fully understand their roles and how proper performance mitigates the risks of material misstatement.

During the process of obtaining an understanding about the financial reporting system, auditors typically gain some knowledge about various monitoring controls or control activities that relate to the processing of transactions and the financial reporting process. In other words, as the auditor learns about how transactions flow through the
accounting system and how those transactions are reported in the financial statements, a by-product of that knowledge is an understanding of how plan management monitors internal control and how certain control activities are applied to achieve accuracy, completeness, cutoff, and other relevant assertions. As a result, many auditors find that it is efficient to gain an understanding of the financial reporting system, internal control monitoring, and control activities components of internal control at the same time. In fact, after the auditor obtains an understanding of the control environment, risk assessment, information and communication, and monitoring, it may not be necessary to devote additional attention to obtaining an understanding of control activities.

Financial Reporting System. The auditor should obtain sufficient knowledge of the financial reporting system, including related processes, as a result of applying risk assessment procedures to understand the following:

a. Classes of Transactions. The classes of transactions in the plan’s operations that are significant to the financial statements.

b. Accounting Procedures. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, and reported in the financial statements.

c. Accounting Records. The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions.

d. Other Events and Conditions. The methods used to capture events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include commitments and contingencies, concentrations, subsequent events, compliance with regulatory matters, related party and party-in-interest transactions, going concern uncertainties, and fair values of investments.

e. Financial Reporting Process. The financial reporting process (including the closing process) used to prepare the plan’s financial statements, including significant accounting estimates and disclosures.

A financial reporting system includes methods and records that:

- Identify and record all valid transactions.
- Provide, on a timely basis, sufficient detailed information about transactions to permit proper classification for financial reporting.
- Allow for the recording of transactions at their proper monetary value in the financial statements.
- Provide sufficient information to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

The auditor’s understanding is at a high level but sufficiently detailed to identify the significant accounting applications, how the computer is used in those applications, and the relative complexity and importance of use of the computer. The auditor also should consider the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors.

Essentially, auditors need to be satisfied that they have a sufficient understanding of the plan’s financial reporting system to understand how material misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation of the financial statements. The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. This typically means that when obtaining an understanding of the financial reporting system, the auditor should obtain knowledge of relevant computer application controls. In a simple financial reporting system, where the auditor assists with the preparation of financial statements and disclosures, this generally will involve:

- Identifying the plan’s significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.
• Understanding the financial close and reporting process, including how information about other events and conditions (that is, other than items included in the plan’s significant transaction classes) is captured for inclusion in the general ledger and financial statements.

• Understanding the extent to which IT is used in the financial reporting system.

The auditor may usually obtain an adequate understanding of the financial reporting system by discussion with plan personnel and review of documents at the plan administrator’s office. A feature of benefit plan financial reporting systems that the auditor should recognize is that the accounting records are often maintained at several locations. AEBP, paragraph 1.27, describes the following accounting records that employee benefit plans generally maintain in addition to the basic accounting records:

• Investment asset records.
• Participant records.
• Contribution records.
• Claim records.
• Distribution records.
• Individual participant account information.
• Administrative expense records.
• General accounting records.
• Reconciliations

AEBP, Paragraph 1.27, points out that, “depending on the type of plan, the allocation of fiduciary responsibilities, and the delegation of administrative duties, records may be maintained by trustees, insurance companies, consulting actuaries, service bureaus, the plan administrator, contract administrators, and plan sponsors.” Employee payroll records, for example, that provide information used to accrue individual participants’ benefits are usually maintained by the employer. The employer’s payroll system is a separate system from the plan’s financial reporting system, but the auditor normally has to gain an understanding of the payroll system to plan the audit of participant data and benefit obligations.

AEBP, Paragraph 6.12, states that if the plan uses a third-party administrator or outside service organization to execute transactions and maintain records on its behalf, the auditor may have to consider the third-party administrator’s or service organization’s internal control in addition to the internal control of the plan.

Risk Assessment Procedures. Risk assessment procedures that are ordinarily performed to understand the financial reporting system include inquiries of plan management and others, observation of plan procedures and controls, inspection of documents and records, and tracing transactions through the system (i.e., walkthroughs). As with the other areas of understanding the plan and its environment, the nature and extent of the procedures performed are affected by factors such as the size of the plan, its complexity, and most certainly, the number of significant transaction classes that exist within the plan.

The existence of any internal documentation that describes classes of transactions and the transaction flow in the accounting system is a key factor that may influence the nature and extent of the auditor’s risk assessment procedures used when obtaining an understanding of the financial reporting system. Typically, such documentation exists for larger and more complex plans and may consist of the following:

• Training manuals for employees.
• Policy and procedure manuals.
Formal memoranda and flowcharts.

Internal audit analyses.

When such documentation exists, the auditor’s risk assessment procedures typically include inspection and review of this documentation, corroborated by inquiries of various personnel to determine if the information is current, observation and walkthroughs to verify that procedures are being followed. While the client’s internal control documentation is an excellent source for understanding and evaluating the design of the financial reporting system, risk assessment procedures consisting of inquiry, observation, and inspection are necessary to ensure that the system has been implemented as designed.

However, for many small plans, the range of control and day-to-day involvement of plan management frequently makes written documentation of the processing systems unnecessary. For those plans the auditor often relies on inquiries of plan management and accounting personnel to understand the design of the financial reporting system. The auditor determines that the system as described has been implemented by performing observation and inspection procedures, such as walkthroughs.

Walkthroughs. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps from initiation to inclusion in the general ledger and the financial statements. This is commonly referred to as a “walkthrough” or “cradle-to-grave” procedure. Walkthroughs may be used to confirm information obtained by inquiry or from prior years’ audits. Walkthroughs are also commonly used in gaining an understanding of related control activities. The AICPA Audit and Accounting Guide, Audit Sampling, notes in Paragraph 3.25 that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions usually involve document inspection, inquiry, and observation. The auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions and related controls through the system from cradle to grave, that is, from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements. The auditor inspects the documents and accounting records used in processing, talks to the personnel involved, and observes the handling of records and related assets. At each step, the auditor does the following:

- Observes the demonstration of, or reperforms, the prescribed manual and automated processing procedure(s) or control(s).
- Identifies and examines the document(s) and IT involved.
- Identifies the name(s) and position(s) of the person(s) who perform(s) the procedure(s) or control(s) and considers the competence and understanding of the person(s) performing the procedure(s) or control(s).
- Determines whether the procedure(s) is (are) performed as prescribed and on a timely basis.
- Identifies the kinds of errors found by the client and the client’s responses to correct them.
- Determines whether the person(s) has (have) been asked to override the procedures or controls.
- Identifies exceptions to the prescribed procedure(s) or control(s).

Some auditors also query individuals about the preceding or succeeding processing step or control activity as a means of obtaining corroborating information about each step in the process. In performing a walkthrough, the auditor should follow the transaction through all of the processing steps in the system. A walkthrough may not be effective if a different transaction is used to test each control separately rather than walking a single transaction through the entire process or if the auditor does not use the same documents and IT that client personnel use. (However, it may be necessary to select additional transactions to verify certain processing steps that may apply for some transactions but not for others. For example, certain of the processing steps and control activities might be different for an employer contribution versus an employee contribution.)

Communication. The auditor should obtain a sufficient understanding of how plan management communicates financial reporting roles and responsibilities and other significant matters. The communication process includes
both internal and external elements. For example, it includes communications between plan management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the plan. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions.

- Any areas where communication does not occur.

Communication is another way that plan management conveys the tone at the top. Management should communicate the information necessary for employees to perform their assigned tasks, for managers to supervise, and for responsible parties to make key operating and financial decisions. Communication also relates to the flow of information upstream in a plan. For upstream communication to occur, there must be open channels of communication and a willingness on the part of plan management to deal with problems. For control activities to be effective, individuals should be able to report exceptions or fraud to the appropriate levels of plan management.

When considering whether a plan has communication controls in place, auditors consider whether plan management has clearly communicated the following:

- That internal control responsibilities are a critical part of employee job duties.

- The role and responsibilities that each employee has in the internal control system.

- That unexpected events should be investigated, including determining the cause of the event.

- How job activities relate to the work of others.

- That communication from employees or participants to plan management regarding problems, controls, potential fraud, or other issues is welcomed and expected.

- That, should an employee or participant feel that taking an issue through the normal upstream communication methods would not be effective, alternative channels of communication are available (such as a direct communication to senior management).

**Risk Assessment Procedures and Factors to Consider.** Communication may be written, electronic, oral, or through the direct actions and involvement of plan management. As a result, auditors often use a combination of risk assessment procedures to understand the communication process. In addition to inquiries of plan management, the auditor may consider the following types of procedures to corroborate plan management’s responses and determine if the communication process as designed has been implemented:

- Inquire of employees regarding the communication that they have received regarding their duties and plan management’s expectations as they relate to financial reporting.

- Review policy and procedures manuals or similar documents that have been provided to employees regarding their duties.

- Review for the existence of training materials or programs on job functions and responsibilities.

- Discuss with human resources personnel the evaluation process and how job knowledge and the performance of responsibilities are incorporated into personnel reviews.

- Inquire of the audit committee and review minutes of meetings regarding the communication between plan management and those charged with governance.

- Inquire of employees regarding how upstream financial communication is received and implemented by plan management.
- Review of whistleblower policies and inspection of documentation regarding reported instances of suspected financial improprieties.

- Inquiry and review of related documentation of how communication from external parties is processed.

**Monitoring**

Monitoring is a process by which a plan assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the plan. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of a plan’s monitoring process include (a) ongoing internal evaluation and (b) reporting of internal control deficiencies.

Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes plan management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. For example, the plan administrator may question reports that differ significantly from his or her knowledge of operations. Because these activities are performed in the normal course of business, ongoing monitoring procedures usually adapt to changing conditions and may be timely in detecting problems. Separate evaluations may involve any aspect of the plan’s system of internal control such as plan management’s review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function.

The auditor should obtain an understanding of the major types of activities that plan management uses to monitor internal control over financial reporting. The auditor’s understanding should include the sources of information related to monitoring and the basis on which plan management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. For example, plan participants, by implicitly corroborating individual participant statements, assist the plan in its monitoring.

**Consideration of Internal Audit Function.** One method some entities use to monitor internal control is through separate evaluations by internal auditors. Many small employers and their employee benefit plans do not have internal auditors. However, if there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. SAS Nos. 65 and 99 provide requirements for inquiries related to the internal audit function.

**Control Activities**

Control activities are the policies and procedures that help ensure that plan management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the plan’s ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what should be done and (b) the procedure that implements the policy. The auditor’s understanding of the other components of internal control, including the control environment, risk assessment, information and communication, and monitoring is used in assessing the risks of material misstatement at both the financial statement and relevant assertion levels. Certain components, such as the control environment, are more important for developing the overall audit strategy. In contrast, control activities are important at the relevant assertion level for detailed planning of the nature, timing, and extent of further audit procedures.

Control activities, which can be either automated or manual, are performed at various levels within the plan. The auditor should obtain an understanding of those control activities relevant to the audit and focus on identifying and obtaining an understanding of control activities that address areas in which the auditor considers material misstatements more likely to occur. The auditor should concentrate on whether and how a specific control activity,
individually or in combination with others, prevents, or detects and corrects material misstatements in the classes of transactions, account balances, or disclosures that are significant to the financial statements. The auditor should also understand how IT affects controls that are relevant to planning the audit.

The categories of control activities that are relevant to the audit are described as follows:

- **Performance Reviews.** Comparisons of current financial reports to other information.

- **Information Processing.** Control activities that are performed to check accuracy, completeness, and authorization of transactions. For information processing systems, there are two broad categories of control activities—application controls and general controls.

- **Physical Controls.** Controls that pertain to the physical security of assets including adequate safeguards that limit access to assets and authorization to access computer programs and files.

- **Segregation of Duties.** The assignment of different people to authorize transactions, record transactions, and maintain custody of assets.

- **Asset accountability.** Controls relating to reconciliations of the detailed records to the general ledger.

Control policies may be communicated either orally or in writing. This will depend to a great extent on the size of the plan and the channels of communication within it. Also critical to control activities are the follow-up actions taken in response to identified discrepancies.

An audit of financial statements does not require an understanding of all control activities related to each class of transactions, account balance, and disclosure or to every relevant assertion. The auditor should first consider the knowledge about control activities obtained from the understanding of the other components of internal control before devoting additional attention to obtaining an understanding of control activities. In obtaining an understanding of who maintains a plan’s investment records and the physical location of securities, for example, the auditor is likely to become aware of control activities concerning safeguarding investments and periodic reconciliation of the investments with the accounting records. The auditor considers this knowledge about control activities in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit and in determining whether additional attention is likely to produce support for an assessed level of control risk below the maximum. Auditing standards specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts, and thus, an understanding or control activities relevant to this reconciliation is always necessary.

The necessity or desirability of devoting additional attention to obtaining an understanding of control activities naturally varies depending on the type of plan, whether the plan is a single-employer or multi-employer plan, whether plan provisions require sponsor or participant contributions or both, the allocation of fiduciary responsibilities, the delegation of administrative duties, the location of records and assets, and whether the plan uses a third-party administrator or outside service organization.

Most likely, the auditor will have to devote additional attention to obtaining an understanding of control activities relevant to participant data, that is, demographic and payroll data. This is always a key audit area because it affects so many other areas of the audit, for example, contributions, plan obligations, etc. Also, the volume of data and level of processing activity is usually relatively high. In contrast, although plan investments are normally significant to a plan’s financial status and are a principal income-generating asset, the auditor is likely to take a primarily substantive approach in that audit area. The same is true for the contributions area for a single-employer plan, for which a primarily substantive approach is usually more efficient. For a multiemployer plan, because of the added complexity, the auditor may devote more attention to control activities in the contributions area. The attention devoted to control activities in the payments area varies considerably depending on the circumstances. Frequently, the level of activity is extremely low and a primarily substantive approach is more efficient.

While a primarily substantive approach is usually more efficient in the investments area because tests of details are more effective than a combination of tests of controls and substantive procedures, the auditor should recognize that in some circumstances a more extensive understanding of control activities may be necessary to design
effective substantive procedures. AEBP, Paragraph 7.13, states that “Sometimes, . . . a plan will not appoint a trustee to maintain custody of the plan’s investments but, rather, will self-administer the investments and investment transactions and provide for their safekeeping with a custodian.” Also, some plans are very active traders and attempt to maximize return by involvement in leveraged buyouts, computerized stock-trading tactics, and high risk investments such as junk bonds. Thus, the auditor should consider whether an understanding of control activities is necessary in the investments area to adequately identify potential misstatements and select appropriate substantive audit procedures.

**Understanding Controls Related to Significant Risks**

The auditor’s understanding of internal control should include the plan’s programs and controls that address identified risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks. Programs and controls addressing fraud risks or other significant risks may relate to any of the five components of internal control; thus, the auditor should use care not to isolate the understanding to only the control activities component. The auditor should be alert to the fact that fraud risks or other significant risks may not be subject to routine controls given the nature of the risk. Also, the auditor’s understanding should extend to whether and how plan management responds to those risks.

Controls that address fraud risks frequently relate to the following:

a. *Control Environment.* Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities.* Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

As with other controls, the auditor should evaluate whether the programs and controls that relate to significant risks are suitably designed and implemented and assess the risks of material misstatement due to error or fraud in light of this evaluation. The existence (or lack) of these programs and controls might either mitigate or increase the risks of material misstatement.

**Documentation**

Thomson Reuters Tax & Accounting provides practice aids that can be used by the auditor to document the understanding of internal control, including the evaluation of design and implementation. When a further understanding of control activities is needed, the auditor can document this understanding using the “Control Activities Forms.” These forms allow the documentation of whether a control addresses a fraud or significant risk and is effectively designed and implemented.

If the auditor devotes additional attention to control activities because he or she believes an assessment of control risk below the maximum level is appropriate (which would permit modification of substantive procedures), the auditor will need to perform tests of controls. The following practice aids have been designed to facilitate documentation of the performance of tests of controls and the results of those tests:

- The “Tests of Controls Form” should be used to describe tests of controls that are to be performed and the conclusion of the tests.
- The “Tests of Controls Sampling Planning and Evaluation Form” is used in addition to the “Tests of Controls Form” to document tests of controls that are performed by applying procedures to a sample of documents. Normally these tests involve inspection of documents and reperformance.

Use of the activity and entity-level control forms and the tests of controls forms should be considered optional. In many cases, these forms are the most convenient means of documenting an understanding of control activities or an assessment of control risk at less than the maximum level. However, in some cases, the auditor may find it more convenient simply to prepare a narrative memorandum that describes certain control activities the auditor believes permit an assessment of control risk at below the maximum level and the results of tests of controls that support that assessment.
Internal Controls, Service Organizations, and Audit Strategy

AEBP, Paragraph 6.10, states that in some cases a third-party administrator, or service organization, executes certain transactions and in some cases maintains the related accountability on behalf of the plan administrator. This service organization may be a bank trustee, an insurance company, a contract administrator, or an EDP service center. In recent years, more and more 401(k) plans provide, through service organizations, daily valuations of plan assets and allow participants to enroll or change contribution percentages and investment allocations by telephone or the Internet. In many cases these options provide no physical record of the election. AEBP provides the following guidance:

- In instances when the plan receives and maintains independent records of transactions executed by the service organization, AEBP, Paragraph 6.11, states that “...the auditor may be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to further audit procedures and to determine the nature, timing, and extent of further audit procedures without considering those components of internal control maintained by the service organization.” An example of such a situation is an arrangement with a bank trust department that invests and services assets for a plan under a nondiscretionary or directed trust. In such a trust the bank executes transactions only as directed by the plan. The plan may also receive and maintain independent records of transactions executed by the service organization when the service organization is authorized by the plan to execute transactions without specific authorization of individual transactions.

- In instances when the plan does not receive and maintain independent records of transactions executed by the service organization, AEBP, Paragraph 6.12, states that “...the auditor may not be able to obtain an understanding of the components of internal control, relevant to [transactions executed by the service organization], sufficient to assess the risks of material misstatement and to determine the nature, timing, and extent of further audit procedures without considering those components of internal control maintained by the service organization.” This is often the case when the service organization is authorized by the plan to execute transactions without specific authorization of individual transactions.

The critical consideration is whether the auditor is able to obtain “a sufficient understanding...” If the plan receives and maintains independent records of transactions executed by the service organization, the authors believe the answer to that question will generally be yes. The authors also believe that the “maintaining of independent records” may include a file of brokerage receipts; a log, kept by the administrator or other responsible official, of purchases and sales based on oral notification of the transactions; a transaction journal; or other such records. Even when the necessary information about the service organization’s internal control is available (by a service auditor’s SAS 70 report or otherwise), the auditor may still find it more efficient to seek a reduction in the assessed level of control risk for assertions related to transactions executed by the service organization by considering the internal control maintained by the service organization.

SAS No. 70 (AU 324), Service Organizations, as amended, applies when a service organization provides services to a plan and those services become part of the plan’s information system. AEBP, Paragraph 6.10, states that a service organization’s services are part of a plan’s information system if they affect any of the following:

- The classes of transactions in the plan’s operations that are significant to the plan’s financial statements.
- The procedures, both automated and manual, by which the plan’s transactions are initiated, authorized, recorded, processed and reported from their occurrence to their inclusion in the financial statements.
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the plan’s financial statements involved in initiating, authorizing, recording, processing and reporting the plan’s transactions.
- How the plan’s information system captures other events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the plan’s financial statements including significant accounting estimates and disclosures.
SAS No. 70, as amended, applies, for example, when an organization such as a bank trust department invests and
services assets for an employee benefit plan. Other service organizations relevant to an employee benefit plan to
which SAS No. 70 applies include third-party administrators, insurance companies that process employee benefit
claims, mortgage servicing agents, and EDP service centers that process transactions and related data for a plan.
SAS No. 70 does not apply to transactions executed by the service organization that are authorized by the plan,
such as checking and cash accounts, the investment of funds in insurance and investment contracts, and the
execution of securities transactions by a broker.

Obtaining an Understanding of Internal Control at the Service Organization. When a plan uses a service
organization, transactions are processed through the service organization’s financial reporting system and are
subject to the service organization’s controls. If the use of the service organization is significant to planning and
performing the audit, the auditor should obtain an understanding of the plan’s financial reporting system and
internal controls for information produced by the service organization. The significance of the services performed
by the service organization should be determined based on the materiality of the account balances and transaction
classes affected by the services and the inherent risk associated with the financial statement assertions of those
balances or classes.

The auditor may obtain information about the service organization’s controls needed to plan the audit from a variety
of sources, such as—

a. User manuals.

b. System overviews.

c. Technical manuals.

d. The contract between the plan and the service organization.

e. Reports by service auditors, internal auditors, or regulatory authorities on the information system and other
   controls placed in operation by the service organization.

f. Inquiring of or observing personnel at the client or at the service organization.

g. If the service organization’s services and the controls over those services are highly standardized,
   information obtained through the auditor’s prior experience with the service organization may be used.

After considering the factors described above and the available information, the auditor should determine whether
he or she has the means to obtain a sufficient understanding of internal control to plan the audit. If there is not
sufficient information to plan the audit, the auditor should consider contacting the service organization (through the
user organization) to obtain specific information or request that a service auditor be engaged to perform proce-
dures to supply the necessary information. Except for the situation described below, a service auditor’s SAS 70
report is generally available for review by the plan auditor. The plan auditor should obtain the most recent service
auditor’s SAS 70 report to gain an understanding of the service organization’s controls.

The plan auditor is cautioned about the significant number of new types of investment instruments that may be held
by plans along with the impact these new and different investment instruments have on increased inherent risk. It
is the plan auditor’s responsibility to review the service auditor’s SAS 70 report and to determine whether these
investments were subject to the service auditor’s audit scope. If the service auditor’s SAS 70 report is unclear as to
scope of coverage, or the plan auditor does not understand the audit scope, the plan auditor should consider
supplementing his or her understanding by discussing with the service auditor the scope and conclusions of their
work. Alternatively, the plan auditor may decide to visit the service organization and perform such procedures. If the
plan auditor is unable to obtain sufficient information by one of these means, he or she should qualify or disclaim
an opinion because of a scope limitation.

In anticipation of the needs of plan auditors and to avoid the need to respond to numerous individual auditors, a
fiduciary may engage a service auditor to report on a description of the aspects of its internal control that are related
to employee benefit plan accounts. This type of report is sometimes called a “single audit report” because it is
prepared by one auditor for use by many other auditors. That term is not used in this book to describe such reports because of the potential confusion with the concept of single audit that applies to governmental units or nonprofit organizations that receive federal financial awards.

In the experience of the authors, many third-party administrators (TPAs) do not have service auditor’s SAS 70 reports available. In such cases, the plan auditor should consider aspects of the TPA’s internal control that may be relevant to the plan’s internal control. That is, those aspects of the TPA’s internal control that directly impact the services the TPA provides the plan. Examples include the TPA’s controls over modification of computer programs and involvement of internal auditors in the review of internal controls. The auditor should then determine the significance of the TPA’s internal control on the plan’s internal control. If an understanding of the TPA’s internal control is necessary and a service auditor’s SAS 70 report is not available, the auditor should consider the procedures discussed above or a site visit of the TPA’s facility.

**Assessing Control Risk.** After obtaining an understanding of internal control, the plan auditor assesses control risk. If the plan auditor wants to assess control risk at below the maximum level, he or she must obtain evidence about the operating effectiveness of the relevant controls. These controls may exist at the plan or at the service organization. SAS No. 70 (AU 324.12) indicates that evidence about operating effectiveness may be derived from the following:

- Tests of the plan’s controls over the service organization’s activities.
- A service auditor’s SAS 70 report on the controls placed in operation and tests of their operating effectiveness or a report on the application of agreed-upon procedures that describes relevant tests of controls.
- Appropriate tests of controls performed by the plan auditor at the service organization.

The most important step for the auditor after obtaining a copy of a service auditor’s SAS 70 report is to read the entire report, including the body of the document that details the individual tests and results. Simply obtaining a copy of the report and placing it in the workpapers by no means constitutes applying sufficient audit procedures. A common finding in peer reviews of employee benefit plan audits is the auditor’s failure to obtain, or properly use, a service auditor’s SAS 70 report. AEBP cautions that a service auditor’s SAS 70 report should not be the sole basis for an assessment of control risk below the maximum. AEBP, Paragraph 6.16, states that “... neither a type I nor a type II report is designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests for all of the assertions relevant to significant account balances or transaction classes.”

While reading the report, the auditor should focus on the services the report covers, as well as any instances of noncompliance with controls.

SAS No. 70 (AU 324.19) states that in considering whether the service auditor’s SAS 70 report is sufficient to meet his objectives, the plan auditor should consider discussing with the service auditor the service auditor’s procedures and results, reviewing the service auditor’s work program, instructing the service auditor about the scope of the work, and reviewing the service auditor’s workpapers. In the authors’ experience, it is generally unnecessary to review the service auditor’s workpapers, provided the plan auditor is satisfied with the independence and the professional reputation of the service auditor. If the plan auditor believes that the service auditor’s SAS 70 report is not sufficient for his or her needs, the plan auditor may have to supplement it with additional discussions, have the plan ask the service organization to request that the service auditor perform additional procedures, or perform them himself or herself. The plan auditor should not accept an internal audit report on the service organization as a replacement for his or her work, or as a replacement of the work of a service auditor. SAS No. 70 (AU 324.14) states that the plan auditor “remains responsible for evaluating the evidence presented by the service auditor and for determining its effect on the assessment of control risk at the user organization.” AU 324.16 also states that “because the [service auditor’s SAS 70] report may be intended to satisfy the needs of several different user auditors, a user auditor should determine whether the specific tests of controls and results in the service auditor’s [SAS 70] report are relevant to assertions that are significant in the [plan’s] financial statements.”
Types of Service Auditor’s SAS 70 Reports. A service auditor is an auditor who reports on the processing of transactions by a service organization. There are three primary types of service auditor’s reports:

a. Reports on Controls Placed in Operation (Type I Report). A report on controls placed in operation expresses an opinion on a description of the controls at a service organization as of a specified date. The opinion indicates whether the controls described are presented fairly in all material respects and were suitably designed to provide reasonable assurance that the control objectives specified in the description would be achieved if complied with satisfactorily. This type of report may be helpful in providing a sufficient understanding to plan the audit. However, this type of report has the following limitations:

1. This type of report is not intended to provide any evidence of the operating effectiveness of controls that would permit assessing control risk below the maximum.

2. The report gives assurance only with respect to the control objectives specified in the description. There is no assurance that the specified objectives include all those that would be relevant to the user.

3. The report may contain a caveat that the stated control objectives may be achieved only if the user applies controls contemplated in the design by the service organization. (The auditor should be alert to this type of caveat and consider whether the plan is applying the necessary procedures. For example, completeness of processing participant payroll information may depend on the plan validating that all payroll records sent were processed by checking a control total.)

b. Reports on Controls Placed in Operation and Tests of Operating Effectiveness (Type II Report). A report on controls placed in operation and tests of operating effectiveness adds tests of controls to the report on design. The service auditor applies tests of controls to determine whether the specified controls in the description are operating with sufficient effectiveness to achieve the specified control objectives. This type of report may be helpful in assessing control risk below the maximum when relevant controls are applied only at the service organization. This type of report is subject to the same limitations as the report on design with respect to specified control objectives. [See items a(2) and a(3).]

c. Reports on Agreed-upon Procedures. A report on agreed-upon procedures may cover tests of controls, substantive tests, or both. If the service auditor is engaged to perform procedures at the request of the plan auditor, the appropriate form of report is an agreed-upon procedures report. Agreement must be reached among the plan and the plan auditor and the service organization and service auditor on the specific procedures to be performed. This type of report may be more effective for the plan auditor than the more general reports on internal control because it can be directed to those controls or financial statement assertions of direct interest to the plan auditor in the circumstances.

When the plan auditor uses a service auditor’s SAS 70 report, according to SAS 70 (AU 324.18), the plan auditor should make inquiries about the service auditor’s professional reputation. These inquiries should be made whether the report is used as part of the plan auditor’s obtaining an understanding of internal control or as part of the support for an assessed level of control risk below the maximum. In addition, for the auditor to use a service auditor’s SAS 70 report, the report must be issued by a licensed CPA. Therefore, the auditor should consider the need to verify that the issuing entity is properly licensed, peer reviewed, and able to provide its peer review report and letter of comments and response.

It is normally not necessary for a plan auditor to perform additional procedures or visit the service organization if the plan auditor determines that the service organization’s controls were in place and effective. However, as discussed in AEBP, Paragraphs 6.22 through 6.24, additional procedures or site visits may be necessary in the following situations:

a. The service auditor issued a report on controls placed in operation, and the plan auditor would like to reduce the assessed level of control risk at the service organization. In this situation, the plan auditor has the option of trying to reduce the assessed level control risk at the service organization or performing additional procedures on the plan’s financial statements. If the plan auditor determines that testing the operating effectiveness of the controls in place at the service organization is more efficient, then appropriate tests of those controls should be performed, normally at the service organization’s location.
b. The service auditor's SAS 70 report addresses a different period than the plan's financial statements. For example, the service auditor’s SAS 70 report may address the year ended September 30, and the plan’s financial statements are for the year ended December 31. In this example, the plan auditor should determine, through inquiries of the service organization or its auditors, whether the service organization changed any of its controls during the three month period not covered by the service auditor’s report. If changes were made in the controls or if the audit period not addressed by the service auditor’s SAS 70 report is significant, the plan auditor should gain an understanding of the controls affecting the plan during that period.

c. The service organization only obtains a service auditor’s SAS 70 report on a rotating basis, such as once every two or three years. If the period covered by the service auditor’s SAS No. 70 report is different from the plan’s reporting period, the plan auditor may obtain a preliminary understanding of controls at the service organization and extend that understanding with additional current information. In this example, the plan auditor should determine, through inquiries of the service organization and its auditors, whether there have been any system changes, significant changes in controls, or mergers or acquisitions that impacted the services provided. If these or similar changes have occurred, the plan auditor should gain an understanding of the changes and their effects on controls.

d. The service auditor’s SAS 70 report does not cover all of the services used by the plan, or the report does not address the activities of a subservice organization provided indirectly to the plan. In this situation, the plan auditor should gain an understanding of those controls applicable to the plan that are not covered in the report. The procedures discussed in a. above should be performed if the plan auditor would like to assess control risk below the maximum. If a service auditor’s SAS 70 report for the subservice organization is available, the plan auditor should obtain a copy and perform the procedures discussed above.

Additional procedures may also be necessary if the service auditor’s report notes instances in which the service organization did not comply with its controls. In this situation, the plan auditor should determine whether these instances of noncompliance affect the assessment of control risk at the service organization. If the instance of noncompliance related to a control not applicable to the plan, the plan auditor needs to apply no further procedures. However, if the instance of noncompliance related to a control directly related to the services provided to the plan, the plan auditor may need to perform additional procedures on the plan’s financial statements or at the service organization.

AEBP Paragraphs 6.25 and 6.26 indicate auditors may consider the following to determine if it is necessary to expand the scope of detailed testing when a service auditor’s SAS 70 report contains exceptions or is qualified:

- Whether the exception or qualification is related to activities of the plan.
- Based on details in the service auditor’s SAS 70 report and inquiries of plan personnel and/or the service auditor, the nature of the exception or qualification.
- Whether the plan or service organization has performed any follow-up procedures and additional testing to address the exception or the reason for the qualification.
- Whether compensating controls exist that would mitigate the effect of the exception or qualification.

Auditors may not be able to rely on a qualified service auditor’s SAS 70 report or may be unable to rely on controls at the service organization if the service auditor’s SAS 70 report contains exceptions. Auditors should consider all relevant facts and circumstances when making that determination.

An interpretation of SAS 70 (AU 9324.04), Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations), addresses the situation when a service organization uses an independent organization to process information. For example, a bank trust department may use an independent computer processing service to process investment transactions. In this example, the bank trust department is a service organization and the computer processing service is a subservice organization. Plan auditors that rely on a service auditor’s SAS 70 report to assess a plan’s control risk should be alert to such arrangements and may need to consider controls at both the service organization and the subservice organization. If such an agreement exists, the
The plan auditor should obtain an understanding of how the relationship between the service providers impacts the plan’s internal control. Consideration should be given to the significance of the relationship between the providers (i.e., what type of transactions occur between the providers and how material are they to the plan?). If the arrangement is considered significant to the plan’s internal control, the plan auditor should consider gathering additional information regarding the controls at the service organization and the subservice organization. The auditor should evaluate the additional information to the extent necessary to gain a sufficient understanding of the plan’s internal control to plan the audit. In practice, the service auditor will sometimes exclude the subservice organization from the scope of his or her engagement. In such cases, the plan auditor should consult the above paragraph that addresses SAS No. 70 (AU 324.19) in evaluating the service auditor’s SAS 70 report.

The plan auditor should not make reference to the report of the service auditor as a basis, in part, for the opinion on the plan financial statements. The service auditor is not responsible for examining any portion of the plan financial statements. Even when a service auditor performs substantive tests, the decisions on the nature, timing, and extent of those procedures are not made by the service auditor.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Stacy is trying to understand the different internal control components of her client. Which of the following would Stacy identify as an "activity-level" control of the internal control structure?
   a. Risk assessment.
   b. Information and communication (excluding the financial reporting system).
   c. Monitoring.
   d. Control activities.

22. If the auditor discovers a control is improperly designed, what action should he or she take?
   a. Fix the control.
   b. Alert the shareholders that a material misstatement may exist.
   c. Communicate the error in control design to management.
   d. Document the design flaw and issue a qualified opinion.

23. Which of the following statements is accurate regarding the auditor’s decision regarding the use of internal controls to assess the risk of material misstatement of the financial statements due to error or fraud?
   a. The auditor should obtain an understanding of every control.
   b. The auditor should understand at least half of the controls.
   c. The auditor should understand the key controls relevant to the audit.

24. Which of the following may be a potential disadvantage of information technology (IT) regarding the effectiveness and efficiency of the plan’s internal control?
   a. Consistency.
   b. Timeliness.
   c. Accuracy.
   d. Information availability.

25. Drew is auditing the benefit plan of TypeSet Electronics. He is looking for factors that could affect the assessment of risk in the audit. Which of the following is a factor that would not affect the risk assessment for the audit?
   a. New accounting staff hired by TypeSet Electronics.
   b. A layoff of hourly workers within TypeSet Electronics.
   c. A sudden surge in participants in TypeSet Electronic’s benefit plan participation.
   d. Restructuring of the benefit plan by TypeSet Electronics.
26. A “walkthrough” is a common method used to trace a transaction through the various processing steps from initiation to inclusion in the general ledger and the financial statements. Walkthroughs may be ineffective in which of the following circumstances?

   a. To confirm information obtained by inquiry.

   b. To confirm information obtained from prior years’ audits.

   c. In gaining an understanding of related control activities.

   d. If the auditor does not use the same documents that client personnel use.

27. During the audit of the benefit plan of her client, Emily is investigating how financial information is communicated in the organization to assess the risk. Which of the following is a suitable communication by the client for Emily to be able to assess risk at a lower level?

   a. The accounting staff at her client have all been in their positions for the last 10 years, so everyone is aware of their responsibilities. There is currently no training manual on the accounting process and the client does not see a need for one since it keeps the procedures controlled.

   b. The controller has a staff meeting with the accounting staff each week to communicate any changes and decide upon implementation within the management of the plan.

   c. Currently, there is not a process designed for participants to communicate to plan management any problems within the benefit plan. Employees of the plan do have a means of communication.

   d. No documentation exists on how communication from external parties is processed by employees or within the plan. Each situation is dealt with individually.

28. In which of the following scenarios would an auditor identify a control environment instead of a control activity?

   a. The benefit plan management of Grass Seed Planters requires that three people within plan management sign off on all plan investments, before the money is distributed.

   b. Plan participants of the employee benefit plan of Tiger Motors are required to sign a form stating they are declining participation in the plan, if they choose to do so.

   c. Supreme Electronics employs an investment analyst to help plan management make informed decisions about investments that would be most beneficial for the benefit plan.

   d. The benefit plan financials of Window Watchers, Inc. are reviewed by the plan administrator and the controller of the plan sponsor.

29. There are three primary types of service auditor’s SAS 70 reports. Which report may cover tests of controls, substantive tests, or both?

   a. Reports on Controls Placed in Operation (Type I Report).

   b. Reports on Controls Placed in Operation and Tests of Operating Effectiveness (Type II Report).

   c. Reports on Agreed-upon Procedures.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

21. Stacy is trying to understand the different internal control components of her client. Which of the following would Stacy identify as an “activity-level” control of the internal control structure? (Page 68)

   a. Risk assessment. [This answer is incorrect. Risk assessment is an internal control component and is referred to as an “entity-level” control.]

   b. Information and communication (excluding the financial reporting system). [This answer is incorrect. Another of the components of internal control referred to as “entity-level” controls is information and communication (excluding the financial reporting system).]

   c. Monitoring. [This answer is incorrect. Monitoring is one of the components of internal control referred to as “entity-level” control.]

   d. Control activities. [This answer is correct. Control activities are one of the interrelated components of internal control, and is referred to as an “activity-level” control. Control activities are important at the relevant assertion level for detailed planning of the nature, timing, and extent of further audit procedures.]

22. If the auditor discovers a control is improperly designed, what action should he or she take? (Page 68)

   a. Fix the control. [This answer is incorrect. An auditor is not responsible for the redesign of the control.]

   b. Alert the shareholders that a material misstatement may exist. [This answer is incorrect. Auditors should not alert shareholders if a control is improperly designed. Auditors should be careful to not create adverse legal action.]

   c. Communicate the error in control design to management. [This answer is correct. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to both management and those charged with governance.]

   d. Document the design flaw and issue a qualified opinion. [This answer is incorrect. While the design flaw would need to be documented in the audit, it may not require the auditor to issue a qualified opinion on the audit. The significance of the design flaw and its affect on the financial statements would need to be considered in the opinion determination.]

23. Which of the following statements is accurate regarding the auditor’s decision regarding the use of internal controls to assess the risk of material misstatement of the financial statements due to error or fraud? (Page 69)

   a. The auditor should obtain an understanding of every control. [This answer is incorrect. It is not necessary for the auditor to obtain an understanding of every control. Doing so would be cost prohibitive and not necessary for most audit engagements.]

   b. The auditor should understand at least half of the controls. [This answer is incorrect. The auditor does not need to understand at least half of the controls in order to assess the risk of material misstatement of the financial statements due to error or fraud per SAS No. 109 (AU 314.48). The auditor should make an informed judgment of the sufficient amount.]

   c. The auditor should understand the key controls relevant to the audit. [This answer is correct. The auditor’s focus should be on those controls that are important to the audit. The auditor should make an informed judgment as to the controls or combination of controls that will be assessed by considering factors such as the size of the plan, the type of plan, number of participants and/or employers, as well as a variety of other factors.]
24. Which of the following may be a potential disadvantage of information technology (IT) regarding the effectiveness and efficiency of the plan’s internal control? (Page 70 and Page 71)

a. Consistency. [This answer is incorrect. The consistency found in automated systems tends to enhance the effectiveness and efficiency of the plan’s internal control.]

b. Timeliness. [This answer is incorrect. One significant advantage of using IT for the plan’s internal control is the timeliness factor versus internal control that does not use computers.]

c. Accuracy. [This answer is incorrect. Much of the human element is avoided with the use of IT for the plan’s internal control, thus improving accuracy of the information.]

d. Information availability. [This answer is correct. The use of IT may impact the availability of information needed for the audit. In highly automated processing with minimal or no manual intervention where information is initiated, authorized, recorded, processed, or reported electronically, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.]

25. Drew is auditing the benefit plan of TypeSet Electronics. He is looking for factors that could affect the assessment of risk in the audit. Which of the following is a factor that would not affect the risk assessment for the audit? (Page 73)

a. New accounting staff hired by TypeSet Electronics. [This answer is incorrect. Hiring new accounting staff can affect the financial statements and thus, affect the risk assessment of the audit of the financial statements. Drew should identify the hiring of new accounting staff by TypeSet Electronics as a risk assessment factor for the audit of the benefit plan.]

b. A layoff of hourly workers within TypeSet Electronics. [This answer is correct. A layoff of hourly workers that are employed by TypeSet Electronics would not be a risk factor in the audit of the benefit plan since the employees did not affect the administration of the benefit plan or the preparation of the benefit plan’s financial statements.]

c. A sudden surge in TypeSet Electronic’s benefit plan participation. [This answer is incorrect. Rapid growth in participation in the benefit plan could create risks in the administration of the benefit plan and could contribute risk factors to the audit of the plan.]

d. Restructuring of the benefit plan by TypeSet Electronics. [This answer is incorrect. Restructuring of the benefit plan could affect the financial statements of the benefit plan and contribute a risk factor to the assessment of the plan.]

26. A “walkthrough” is a common method used to trace a transaction through the various processing steps from initiation to inclusion in the general ledger and the financial statements. Walkthroughs may be ineffective in which of the following circumstances? (Page 77)

a. To confirm information obtained by inquiry. [This answer is incorrect. Information obtained by inquiry may be confirmed by a walkthrough since the auditor should be able to verify the queried information during the walkthrough.]

b. To confirm information obtained from prior years’ audits. [This answer is incorrect. Information obtained from prior years’ audits may also be substantiated by a walkthrough. The auditor would be able to view the documents and processes from the previous audits.]

c. In gaining an understanding of related control activities. [This answer is incorrect. Walkthroughs are also routinely used in gain an understanding of related control activities. The related control activities can be validated as a working control during the walkthrough.]

d. If the auditor does not use the same documents that client personnel use. [This answer is correct. A walkthrough may not be effective if the auditor does not use the same documents and IT that client personnel use.]
personnel use or if a different transaction is used to test each control separately rather than walking a single transaction through the entire process.]

27. During the audit of the benefit plan of her client, Emily is investigating how financial information is communicated in the organization to assess the risk. Which of the following is a suitable communication by the client for Emily to be able to assess risk at a lower level? (Page 78)

a. The accounting staff at her client have all been in their positions for the last 10 years, so everyone is aware of their responsibilities. There is currently no training manual on the accounting process and the client does not see a need for one since it keeps the procedures controlled. [This answer is incorrect. One audit procedure to assess the communication risk is to review policy and procedures manuals that have been provided to employees regarding their duties. A training manual is a documentation of the controls and responsibilities of each position. If there is no manual, the only communication is oral and steps could be overlooked by the employees.]

b. The controller has a staff meeting with the accounting staff each week to communicate any changes and decide upon implementation within the management of the plan. [This answer is correct. Proper communication is observing how employees are notified of upstream financial communication and how the information is implemented within the plan. A weekly staff meeting would be a great way for the information to be filtered down to the employees. This is a good communication process for Emily to be able to assess risk at a lower level.]

c. Currently, there is not a process designed for participants to communicate to plan management any problems within the benefit plan. Employees of the plan do have a means of communication. [This answer is incorrect. When considering whether a plan has communication controls in place, an auditor would need to consider whether plan management has clearly communicated whether information from employees or participants to plan management regarding problems, controls, potential fraud, or other issues is welcomed and expected. Since plan management has not designed a process for participants to communicate any issues, Emily would have to assess risk on this communication process at a higher level.]

d. No documentation exists on how communication from external parties is processed by employees or within the plan. Each situation is dealt with individually. [This answer is incorrect. To assess risk at a lower level for communication, the auditor should inquire and review related documentation regarding how communication from external parties is processed by plan management. Since there is currently no documentation by the plan, the auditor would have no documentation to review nor any procedures to observe.]

28. In which of the following scenarios would an auditor identify a control environment instead of a control activity? (Page 81)

a. The benefit plan management of Grass Seed Planters requires that three people within plan management sign off on all plan investments, before the money is distributed. [This answer is incorrect. Requiring signatures of management would be an example of a control activity, since it is a specific control that is designed to mitigate the risk of money being invested without proper authorization.]

b. Plan participants of the employee benefit plan of Tiger Motors are required to sign a form stating they are declining participation in the plan, if they choose to do so. [This answer is incorrect. Documentation of declining a plan would be an illustration of a control activity, not control environment. The activity of requiring a form is to prevent any fraudulent enrollment or declination in the plan.]

c. Supreme Electronics employs an investment analyst to help plan management make informed decisions about investments that would be most beneficial for the benefit plan. [This answer is correct. A control environment is defined as programs designed to prevent, deter and detect fraud. By employing an investment analyst that has the benefit plan’s best interest at heart, the benefit plan is promoting a culture of honesty and ethical behavior.]
d. The benefit plan financials of Window Watchers, Inc. are reviewed by the plan administrator and the controller of the plan sponsor. [This answer is incorrect. A review conducted by a party not within the plan administration is an example of a control activity that is conducted to ease the chance of fraud within the financial statements.]

29. There are three primary types of service auditor’s SAS 70 reports. Which report may cover tests of controls, substantive tests, or both? (Page 85)

   a. Reports on Controls Placed in Operation (Type I Report). [This answer is incorrect. A report on controls placed in operation expresses an opinion on a description of the controls at a service organization as of a specified date.]

   b. Reports on Controls Placed in Operation and Tests of Operating Effectiveness (Type II Report). [This answer is incorrect. A report on controls placed in operation and test of operating effectiveness adds tests of controls to the report on design.]

   c. Reports on Agreed-upon Procedures. [This answer is correct. A report on agreed-upon procedures may cover tests of controls, substantive tests, or both. If the service auditor is engaged to perform procedures at the request of the plan auditor, the appropriate form of report is an agreed-upon procedures report.]
EXAMINATION FOR CPE CREDIT
Lesson 2 (EBPTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook.

15. Which of the following measures is most important for members of the audit team to take to improve their knowledge of the client and the industry?
   a. Talking to client personnel.
   b. Taking self-study courses.
   c. Reading industry publications.
   d. Reliance on past experience.

16. The firm of Brown and Biddle has been engaged to audit the employee benefit plan of Brownstone Builders. Harry has been assigned to the audit and is currently working on planning the engagement by reading the plan document. Which of the following is information that Harry should observe when reading the document?
   a. Whether the plan is self-funded or insured.
   b. The tax status of the plan.
   c. Compliance with DOL regulations.
   d. The nature of the benefits promised by the plan.

17. Sean is auditing the health benefit plan of his client, a local hospital, that has 250 members in the plan. Is Sean’s audit subject to HIPPA regulations?
   a. Yes.
   b. No.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

18. Which of the following would an auditor determine in a benefit plan audit?
   a. The benefit plan’s objectives.
   b. The benefit plan’s investment strategy.
   c. The operational approach to the benefit plan.
   d. The risk of material misstatement.

19. When evaluating whether a fraud risk factor is present, auditors should consider which of the following?
   a. Significance.
   b. Importance of modifying language.
   c. Mitigating controls.
   d. Materiality.
20. For misappropriation of assets, the consideration of fraud risk factors is most influenced by which of the following?
   a. Risk factors related to incentives/pressures.
   b. Opportunities arising from control deficiencies.
   c. Degree to which assets susceptible to misappropriation are present.
   d. Attitudes/rationalizations for misappropriation.

21. Which of the following is required by SAS No. 109 concerning the auditor’s responsibility for the internal control structure?
   a. The auditor should acquire an understanding of a client’s internal control structure.
   b. The auditor should design the client’s internal control structure.
   c. The auditor is responsible for testing all facets of a client’s internal control structure.
   d. The auditor should document the features of the client’s internal control structure.

22. Kaitlyn is evaluating the design of the internal control structure of her client to see if the controls have been implemented. Which of the following procedures, coupled with questioning the employees, would be effective in her assessment?
   a. Observation.
   b. Documentation.
   c. Vouching.
   d. Confirmation.

23. At what level is the auditor’s understanding of internal control required to be, to assess the risk of material misstatement in the financial statements due to error or fraud?
   a. Superficial.
   b. Sufficient.
   c. Complete.
   d. Absolute.

24. The effect of information technology (IT) on the client’s internal control is related least to which of the following factors?
   a. The nature of the system.
   b. The complexity of the system.
   c. The client’s size.
   d. Do not select this answer choice.
25. Caleb is employing the use of an IT specialist to gain an understanding of the IT system and how it relates to the internal control structure of his client. What is Caleb’s responsibility when utilizing an IT specialist on an engagement?

- a. Caleb can only employ another member of his firm to use an IT specialist, since his firm was engaged to perform the audit.
- b. If Caleb hires an IT specialist, he is no longer responsible for the IT part of the audit as it relates to the internal control structure.
- c. Caleb should have a basic understanding of the computer applications and controls so that he can communicate with the IT specialist.
- d. Do not select this answer choice.

26. A financial reporting system includes methods and records that do each of the following except:

- a. Recognize and record all transactions, regardless of whether valid or invalid.
- b. Provide adequate detailed information about transactions for proper classification for financial reporting.
- c. Provide sufficient information necessary to record transactions in the proper accounting period.
- d. Allow for the recording of transactions at their proper monetary value in the financial statements.

27. If internal documentation exists that describes classes of transactions and the transaction flow in the accounting system, such information is a key factor that may influence the nature and extent of the auditor’s risk assessment procedures. Typically, such documentation is available for which of the following?

- a. Smaller and less complex plans.
- b. Larger and more complex plans.
- c. The size of the plan is not relevant.
- d. Do not select this answer choice.

28. Control activities that are relevant to the audit are policies and procedures that pertain to a variety of actions. Which of the following policies and procedures address controls that are performed to check accuracy, completeness, and authorization of transactions?

- a. Performance reviews.
- b. Information processing.
- c. Segregation of duties.
- d. Asset accountability.

29. Several forms can be used by the auditor to document the understanding of internal control, including the evaluation of design and implementation. Which form using the PPC approach allows the auditor to document whether a control activity addresses a fraud or significant risk and is properly designed and implemented?

- a. Activity and Entity-level Control Form.
- b. Tests of Controls Form.
- c. Tests of Controls Sampling Planning and Evaluation Form.
- d. Do not select this answer choice.
Lesson 3: Audit Planning Decisions and Judgments, Audit Sampling, Audit Plans and Workpapers, and Special Planning Considerations in Initial Engagements

INTRODUCTION

The information the auditor obtains about the plan and its environment by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments based on this information are as follows:

a. The materiality level for the financial statements taken as a whole (preliminary planning materiality).

b. Materiality for particular items of lesser amounts than planning materiality.

c. The risks of material misstatement at the financial statement level.

d. The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).

e. Tolerable misstatement at the individual class of transactions, account balance, or disclosure level.

f. Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.

g. The specific nature, timing, and extent of further audit procedures.

Because the audit planning process is iterative and continuous, some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify audit planning considerations for employee benefit plans as well as timing and coordination considerations.
- Describe audit sampling, detailed audit plans and workpapers, and special planning considerations.

Determining Materiality at the Financial Statement Level

According to SAS No. 107 (AU 312.27), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as planning materiality. SAS No. 107 (AU 312.69) states that the auditor should document the levels of materiality, including any changes thereto, used in the audit and the basis on which those levels were determined. The need to establish planning materiality is directly related to the auditor’s objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. According to SAS No. 107 (AU 312.36), the auditor should be alert for misstatements that could be qualitatively material, but it ordinarily is not practical to design audit procedures to detect them.

Quantifying Planning Materiality. Materiality is determined based on the auditor’s understanding of the needs and expectations of users of financial statements, but this is a conceptual view. In other words, the auditor
considers the needs and expectations of hypothetical general users and does not survey the actual users. In determining planning materiality, the focus is generally on quantitative factors. Thus, auditors have historically used some common rules of thumb in establishing planning materiality.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. SAS No. 107 (AU 312.28) acknowledges the appropriateness of this approach and suggests the following factors to consider in selecting a benchmark:

- Elements of financial statements (for example, assets, liabilities, net assets, net additions, and distributions) and GAAP financial statement measures (for example, financial position).
- Nature and size of the plan.
- Focus of users’ attention for the plan on particular financial statement items.

The appropriate benchmark and the related percentage applied to it can vary with the circumstances. For an employee benefit plan, .5–1% of total (or net) plan assets might be an appropriate rule of thumb. Many auditing firms prefer to use an approach to planning materiality that allows the firm to establish planning materiality as a matter of firm-wide policy to achieve consistency in application and year-to-year stability and predictability in audit approach. To achieve these objectives, the firm may preselect the benchmark and percentage to be used across all of the firm’s audits.

SAS No. 107 (AU 312.30) makes clear that “once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited.” In some employee benefit plans, financial statements include elements with a high degree of estimation uncertainty, such as provisions for incurred but not reported claims for health and welfare plans. A user’s needs and expectations might be influenced by knowledge of the degree of inherent uncertainty associated with such measurements, but the auditor’s materiality judgments in planning and evaluation should not be affected by the degree of uncertainty. In other words, for audit purposes a high degree of measurement uncertainty does not cause the auditor to follow different judgments than those applicable to other plans.

**Desirability of a Single Benchmark.** The desirability of a single benchmark arises from the practical requirements of audit planning. To understand the use of materiality in planning, it is helpful to contrast planning with evaluation. When the auditor is evaluating the materiality of misstatements at the conclusion of the audit, different materiality levels may be used for different financial statements. In planning, however, the auditor does not know in advance whether the misstatements that will be detected by a particular audit test will affect the statement of net assets, statement of changes in net assets, or both statements. Thus, using several levels of materiality is impractical in planning. Also, the auditor should use a specific amount in making decisions about the scope of a test; for example, examine all cash disbursements in the subsequent period above a specific dollar amount. A range is not useful for making scope decisions but may be helpful in evaluation; for example, deciding that in particular circumstances an error over $10,000 is material, an error under $5,000 is immaterial, and an error between $5,000 and $10,000 may be material. That type of guide can be useful in evaluation, but it does not work well in planning. The auditor needs to decide whether an audit test must be extensive enough to detect misstatements over $5,000 or over $10,000.

**Recommended Benchmark.** The recommended approach for determining an amount material to the financial statements for planning purposes is to use either total (or net) plan assets or total additions to plan assets as the benchmark. This benchmark has the advantages of relative stability, predictability, and representativeness of plan size. Using these criteria, total (or net) plan assets or total additions to plan assets often provides a sound benchmark. Nevertheless, the auditor should identify whether there are financial statement items on which, for the particular entity, users’ attention tends to be focused. If a financial statement item is more important to users than total additions to plan assets or total (or net) plan assets, then the auditor should estimate the planning materiality amount using that financial statement element as the benchmark.

AEBP, Paragraph 5.33, indicates benchmarks for employee benefit plans may include the following:

- Net assets.
Net assets as of the beginning of the year when a plan has been merged out of existence during the audit period.

Total contributions or total benefits paid when a health and welfare benefit plan has a small amount of net assets.

Benefit payments when a plan is terminating.

Allocated net assets or outstanding loan balance for an ESOP plan that has negative net assets.

Regardless of the benchmark used for planning the extent of audit testing, the auditor should be satisfied that the combined effects of the nature, timing, and extent of planned procedures will be adequate to obtain reasonable assurance that the financial statements are free from material misstatement, even if a different materiality benchmark is used for evaluation of audit differences.

It is important to note that a planning materiality benchmark is used primarily to plan the extent of audit testing, but does not necessarily purport to provide a basis for determining the adequacy of other aspects of audit planning; namely, the nature and timing of procedures. Also, the choice of a benchmark for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit.

Selecting a Percentage. There are no authoritative percentage guides for materiality. Neither SAS No. 107 nor AEBP contain guidance on selecting a percentage. Using total (or net) plan assets or total additions to plan assets as a benchmark means the audit scope will be driven by the size of the plan. Many auditors believe intuitively that this is appropriate because it agrees with their own past experience in making judgments about audit scope. Also, for intuitive reasons, many auditors believe that the materiality percentage should be adjusted in relation to the size of a plan. They believe the percentage should be larger for a very small plan to recognize the practical limits on the effectiveness of audit procedures and smaller for a very large plan to recognize the increased risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material.

Planning materiality judgments should be reconsidered as the audit progresses. Because the calculation made during initial planning often uses unadjusted financial information, the amounts in the annual audited financial statements might differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments should made. At the conclusion of the audit, the auditor should consider whether the scope of the audit has been adequate in the circumstances. If planning materiality based on unadjusted amounts is too large, then audit scope might not have been sufficient. If planning materiality based on unadjusted amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Materiality for Particular Items of Lesser Amounts

In addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the plan, misstatements of particular items of lesser amounts than planning materiality could be expected to influence economic decisions of users. According to SAS No. 107 (AU 312.31), “any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements” for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor should determine whether there are particular financial statement items for which a lower planning materiality amount is appropriate based on user perceptions of the particular items.

The auditor should consider consulting with management and those charged with governance about whether there are particular financial statement items of lesser amounts than planning materiality that users would regard as material.

Determining Tolerable Misstatement

The auditor must perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements.
For this purpose, the auditor needs to establish a tolerable misstatement at the individual account balance, class of transaction, or disclosure level. SAS No. 107 (AU 312.34) defines tolerable misstatement as “the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept.” SAS No. 107 (AU 312.69) requires documentation of the level of tolerable misstatement, the basis on which it was determined, and any changes thereto as the audit progresses.

Guidance on determining tolerable misstatement is provided in SAS No. 107 (AU 312.35), which indicates, “the auditor should determine one or more levels of tolerable misstatement,” and such levels are “normally lower than the materiality levels.” In other words, generally tolerable misstatement should be lower than the materiality level for the financial statements taken as a whole. Also, for particular items in the financial statements for which a lesser amount than financial statement materiality has been determined, the tolerable misstatement should be commensurately lower as well. Therefore, the auditor may determine and document more than one level of planning materiality and more than one level of tolerable misstatement.

SAS No. 39 (AU 350.18), Audit Sampling, as amended by SAS No. 111, provides the following additional guidance on tolerable misstatement:

This maximum monetary misstatement that the auditor is willing to accept for the balance or class is called tolerable misstatement for the sample. Tolerable misstatement is a planning concept and is related to the auditor’s determination of materiality for planning the financial statement audit in such a way that tolerable misstatement, combined for all of the tests in the entire audit, does not exceed materiality for the financial statements. This means that auditors should normally set tolerable misstatement for a specific audit procedure at less than financial statement materiality so that when the results of the audit procedures are aggregated, the required overall assurance is attained.

Although this guidance appears in relation to audit sampling, it is applicable to all further audit procedures not just those involving sampling.

In contrast to this general guidance, tolerable misstatement in an employee benefit plan engagement is often equal to planning materiality. The reason for this is that all known misstatements detected during the audit are generally corrected. That is, uncorrected known misstatement is zero and sampling is rarely used for substantive tests of transactions or balances, so projected or estimated misstatement is negligible. All known misstatements are likely to be corrected because of the DOL’s potential enforcement action against the plan for failing to properly calculate and maintain individual participant accounts in a defined contribution plan. Uncorrected known misstatements, even if immaterial to the plan, could lead to incorrect calculations of income accruals and distributions at the participant level. If the misstatements are detected by the DOL during an audit, the plan could be required to pay additional benefits and possibly fines. Also, any differences between Form 5500 and the audited financial statements need to be reported. Thus, the fiduciary responsibilities generally lead plan management to be conservative and all detected misstatements are normally corrected.

A concept closely related to tolerable misstatement is individually significant items. This term encompasses two types of items in a financial statement component. These include:

- Unusual items (that is, items that have audit significance by their nature).
- Individually significant dollar items.

Generally, when performing tests of details, the auditor should at least examine all items that equal or exceed tolerable misstatement. Accordingly, the cutoff amount for determining individually significant dollar items generally should not exceed tolerable misstatement. As a rule of thumb, the auditor may use one-third of tolerable misstatement as the cutoff for individually significant dollar items. However, the auditor may choose any amount less than tolerable misstatement to limit the remaining balance to an amount that reduces the risk of material misstatement to an acceptable level. In an employee benefit plan engagement, the concept of individually significant items is usually a more important driver of audit scope than the concept of tolerable misstatement.
Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

The auditor must consider audit risk for the financial statements taken as a whole. When considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. (These risks are also referred to as overall risks.)

Auditing standards establish a presumptively mandatory requirement for the auditor to assess and document the risks of material misstatement at the financial statement level (SAS No. 107, AU 312.12 and SAS No. 109, AU 314.122). Risks of material misstatement at the financial statement level often relate to the plan’s control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. These overall risks are often especially relevant to the auditor’s consideration of the risks of material misstatement arising from fraud, for example, through plan management override of internal control.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. Some auditors have questioned whether these risk model components also need to be considered at the financial statement level. The answer is, “No.” It is believed the risk assessment at the financial statement level is directed to an overall or combined assessment of the risk of material misstatement. There is no requirement to separately assess inherent risk and control risk at the financial statement level. The overall assessment of risk of material misstatement at the financial statement level is made relatively early in audit planning, based on information such as the effectiveness of the plan’s control environment and identification of fraud risk factors.

SAS No. 110 (AU 318.04) provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include:

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

Because there is always at least one identified fraud risk (a risk of management override of controls), certain overall responses are required in every audit, as follows:

- Auditors should consider whether the personnel assigned to the engagement possess the necessary knowledge and skills.
- Auditors should consider whether the extent of supervision of personnel is appropriate.
- Auditors should consider the client’s selection and application of accounting principles, especially in subjective areas.
Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks.

Before considering how to assess the risk of material misstatement at the assertion level, the auditor needs to understand several basic concepts, including:

- The audit risk model;
- The risk of material misstatement;
- Relevant assertions.

**The Audit Risk Model**

SAS No. 107 (AU 312.20) states that audit risk (AR) for relevant assertions related to account balances, classes of transactions, or disclosures consists of the following:

- The risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to account balances, transaction classes, or disclosures.

- The risk (detection risk) that the auditor will not detect such misstatements.

The way the auditor should consider these component risks and combine them involves professional judgment and depends on the auditor’s approach or methodology.

Audit risk components are defined as follows:

a. **Inherent Risk (IR).** The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

b. **Control Risk (CR).** The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the plan’s internal control.

c. **Detection Risk (DR).** The risk that the auditor’s procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.

Detection risk is a function of the effectiveness of the substantive procedures applied by the auditor and can be disaggregated into additional components of test of details risk (TD) and substantive analytical procedures risk (AP). The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor.

**Risk of Material Misstatement**

The risk of material misstatement is a combination of inherent risk and control risk. The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks encompass both inherent and control risk attributes. Therefore, the auditor’s separate assessments of inherent and control risk should include consideration of the risk of material misstatement due to fraud. The product of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

\[ RMM = IR \times CR \]

Inherent risk and control risk are the plan’s risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor’s combined assessment of the two risks. The auditor...
may make an overall, or combined, assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. Thus, at the relevant assertion level, the audit risk model is as follows:

\[ \text{AR} = \text{RMM} \times \text{DR} \]
\[ \text{DR} = \text{TD} \times \text{AP} \]

In planning a particular test of details, the detection risk is established by the following relationship:

\[ \text{TD} = \frac{\text{AR}}{\text{RMM} \times \text{AP}} \]

This model is not intended to be a mathematical formula including all factors that influence the assessment of audit risk, but some auditors find such a model in its formula form to be useful.

AEBP, Paragraph 5.28, notes that “a few areas presenting particular risks of material misstatement when auditing employee benefit plans are (a) the fair market value of investments with no readily ascertainable market, (b) new types of investments, (c) benefit amounts, (d) transactions initiated by telephone or electronic means (such as the Internet or Intranet), and (e) contributions are accurately calculated and remitted on a timely basis.”

**Relevant Assertions**

An assertion is a relevant assertion if it has a meaningful bearing on whether the class of transactions, account balance, or disclosure is materially misstated. For example, the valuation assertion for cash is ordinarily not relevant unless foreign currency translation is involved. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the plan processes and controls information supporting the assertions.

**Assessing the Risk of Material Misstatement at the Relevant Assertion Level**

The assessment of audit risk at the relevant assertion level, whether made in quantitative terms (e.g., percentages) or nonquantitative terms (e.g., high, moderate, or low), is a judgment rather than a precise measurement of risk. The auditor should have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the plan and its environment.

The only time that use of the formula for the audit risk model and specific percentages is necessary is when statistical sampling is used, but the formula can be useful in other circumstances as well. SAS No. 111 (AU 350.20) provides the following guidance on using the risk model to determine detection risk for a test of details using audit sampling:

\[ \ldots \text{the auditor should determine an acceptable audit risk and subjectively quantify his or her judgment of the risk of material misstatement (consisting of inherent risk and control risk), and the risk that substantive analytical procedures and other relevant substantive procedures would fail to detect misstatements that could occur in an assertion equal to tolerable misstatement . . .} \]

In other words, the auditor’s quantification of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation. Whichever method is used, the auditor’s assessment of audit risk at the relevant assertion level is a judgment rather than a precise measurement of risk.
AEBP, Paragraph 5.41, indicates an employee benefit plan may include the following risks of misstatement at the assertion level:

- Investments do not exist, are not valued at fair value, and are not shown properly by investment type in the statement of net assets available for benefits and are not properly disclosed.
- Claims and benefit payments have not been paid in accordance with the plan document.
- Employer contribution income is not properly recognized and is not complete with respect to accruals, including amounts due at the end of the period, a valuation for amounts deemed uncollectible, and the present value of any employer withdrawal liability (for multiemployer plans).
- Participant data used to calculate plan benefit obligations are not complete.
- Transactions with parties in interest have not been properly shown in the plan’s financial statements.
- Plan expenses have not been recorded in the proper amount, in the proper accounting period and in accordance with the plan document.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. (An audit area encompasses the related account balances, transaction classes, and disclosures.) The following factors should be considered in determining which audit areas are significant:

- Relative materiality of the account balance to the overall financial statements.
- Relative significance of the transaction class to the plan’s operations or the overall financial statements (for example, because of either the materiality or volume of transactions flowing through the account during the period).
- The susceptibility of the account balance or transaction class to fraud, including both theft and similar loss of related assets and intentional misstatement by plan management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in individual audit areas to ensure their accuracy and completeness.

Materiality of the Account Balance to the Financial Statements. One element of significance is the dollar amount of an account balance in relation to the auditor’s judgment of the amount material to the financial statements taken as a whole. Judgment is required even in making these quantitative comparisons because account balances are usually not completely misstated. Account balances other than liabilities and valuation allowances with an ending balance below tolerable misstatement would generally be regarded as quantitatively immaterial and not significant. Account balances that are some multiple of tolerable misstatement are generally quantitatively significant. Account balances that are approximately equal to tolerable misstatement require careful consideration as to the nature of the account balance and prior experience with the client in evaluating significance.

Relative Significance to the Financial Statements. The auditor’s risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Those risks are discussed in the following two subsections.
Significant Risks Requiring Special Audit Consideration. The auditor should determine which of the risks identified by risk assessment procedures are risks that require special audit consideration. The auditor’s determination of significant risks should be based primarily on the consideration of inherent risk, that is, it should be before consideration of the effect of identified controls related to the risk. The auditor should determine whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the risk.

- The magnitude of the potential misstatement, including the possibility of multiple misstatements.

- The likelihood of the risk occurring.

Each of these aspects of the auditor’s consideration needs attention in determining whether special audit consideration is required, but the nature of the risk is particularly important.

The nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud or theft?

- Is the risk related to recent significant economic, regulatory, accounting, or other developments?

- Are the transactions complex?

- Does the risk involve significant transactions with related parties or parties in interest?

- Is there a relatively large degree of subjectivity in the measurement of the financial information related to the risk?

- Does the risk involve significant nonroutine transactions outside the normal course of business or that otherwise appear unusual?

- Hypothetically, if the auditor had a time constraint to perform the audit, would the risk be one that would absolutely need to be addressed through substantive tests of details?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor’s risk assessment, he or she should identify those risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the plan’s information is initiated, authorized, recorded, processed, or reported electronically. An example of this situation could be participant accounts in a defined contribution plan that are maintained by a third-party administrator and allow participants to enroll, change elections, and withdraw electronically. In such situations, it might not be possible or practicable to perform only substantive procedures in response to a risk because of the importance of effective controls over the accuracy and completeness of available audit evidence.

Significant Risks in an Employee Benefit Plan Audit

Employee benefit plans are subject to significant risks like any other entity. AEBP, Paragraph 5.68, lists a number of potential significant risks relevant to employee benefit plan audits. Those risks are summarized in Exhibit 3-1.
Exhibit 3-1

Potential Significant Risks in an Employee Benefit Plan Audit

For all plans:

- Hard-to-value investments not valued at fair value.
- Insufficient disclosure of the basis for valuation of hard-to-value investments.
- Valuation of non-readily marketable investments in partnerships and common and collective funds not based on reporting date values.
- New accounting guidance not properly applied.
- Improper accounting for and disclosure of derivatives.
- Improper presentation or disclosure of securities lending transactions.
- Incomplete transfer of assets when a plan has received a transfer of assets from another plan.
- A service auditor’s SAS 70 report is not available when significant transactions are processed by an outside service provider.
- A service auditor’s SAS 70 report includes qualifications, exceptions, or carve-outs when significant transactions are processed by an outside service provider.

For Defined Contribution Plans:

- Incorrect calculation of employee and employer contributions due to the use of an improper definition of compensation.
- The plan has not complied with the DOL’s regulations for the timely remittance of participant contributions to the trustee or custodian.
- When a plan has changed recordkeepers or there is a transfer of assets from another plan, the individual account balances are not properly maintained.
- The company stock in a private company ESOP is not correctly valued at fair value.

For Health and Welfare Benefit Plans:

- Not reflecting all activity of a health and welfare plan in the financial statements.
- Improper determination or recording of IBNR claims.

For Defined Benefit Plans:

- Inaccurate accounting for the hypothetical balances in an ongoing cash balance defined benefit pension plan due to the improper application of the interest rate, service credits, or beginning balances.
- Misstating the beginning balance of the hypothetical accounts in the year a defined benefit pension plan is converted to a cash balance benefit formula.
- Using incorrect demographic information in a frozen plan.
- Improper calculation of benefit payments, including lump-sums.
• Incorrect calculation of benefit payments for a terminated plan.

• Incorrect calculation of benefit payments when the plan uses different benefit formulas for various time periods for employee groups.

• Improper recording or valuation of an employer contribution receivable when the plan sponsor is experiencing financial difficulty.

*          *         *

Accounting Estimates. Another area of risk of material misstatements at the balance or class level is accounting estimates. AEBP, Paragraph 5.124, states that "certain areas of employee benefit plans operations require accounting estimates that may be material in the preparation and presentation of financial statements." The following are examples of such estimates:

a. Fair market valuation of securities with no readily available market quotation, such as restricted securities and real estate.

b. Actuarial assumptions used in the actuarial present value of accumulated plan benefits, such as the assumed rate of return on plan assets.

c. Claims incurred but not reported for an uninsured (self-insured) health and welfare benefit plan.

d. Postretirement and postemployment benefit obligations.

e. Accumulated eligibility credits for health and welfare benefit plans.

f. Accrued experience rating adjustments on insurance contracts.

Investments are usually very significant to the financial status of an employee benefit plan. Also, there are numerous risks associated with investments. For these reasons, investments is a critical audit area in an employee benefit plan engagement. AEBP, Paragraphs 7.02 to 7.04, draws attention to the changing nature of pension and benefit plan investment portfolios. Plans were once considered to follow conservative investment policies and approaches. Now plans invest in newer forms of investments with increased inherent risk, for example, repurchase or reverse repurchase agreements, futures and options, collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and other securitized portfolio investments. AEBP, Paragraph 7.05, states that "Except in the case of a limited-scope audit, the auditor should obtain an understanding of the plan’s process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach."

Parties in Interest and Prohibited Transactions. AEBP, Paragraph 11.19, points out that ERISA requires the auditor to report all prohibited transactions, unless exempted from prohibited transaction rules of which he or she is aware, whether or not material. DOL officials place a great deal of emphasis on the reporting of prohibited transactions and believe that auditors have a significant role in encouraging compliance with ERISA and related regulations. For these reasons, parties in interest and prohibited transactions are very significant audit risk areas in an employee benefit plan engagement. The auditor may conclude that misstatements in this area require use of a lower planning materiality amount.

The definition of parties in interest is very broad. Parties in interest include the plan sponsor or employer, fiduciaries (including those who provide investment advice or who have discretionary control over plan assets), and those who provide services to the plan. This means that virtually everyone who engages in transactions with the plan is a party in interest. Transactions with these parties are prohibited transactions if ERISA specifically identifies them as prohibited, such as loans to a sponsor. Transactions with these parties are generally prohibited except for transactions that are specifically permitted (those that are exempt from the prohibition). Exemptions can be by fiduciary or transaction or by classes of fiduciaries or transactions. Exemptions are discussed in ERISA Section 408 Certain transactions are specifically prohibited as discussed at ERISA Section 406. (In addition to such statutory or administrative exemptions, a plan may request a specific exemption from the DOL.)
During audit planning, the auditor should consider the potential for material prohibited transactions. During the performance of the audit, when examining transactions, the auditor should consider whether they involve parties in interest and are prohibited transactions. When prohibited transactions are detected, AEBP, Paragraph 11.17, requires the auditor to consider whether they have adverse implications on other aspects of the audit, particularly on the auditor’s ability to rely on management representations. The paragraph points out that “the implications of particular prohibited transactions will depend on the relationship of the perpetration and concealment, if any, of the transactions to specific control [activities] and the level of management or employees involved.” For example, a prohibited transaction engaged in by a high level plan official would have more serious audit implications.

**Establishing an Overall Audit Strategy**

The auditor should establish an overall strategy for the audit. The audit strategy is the auditor’s operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach. It includes the identification of overall risks, the overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. SAS No. 108 (AU 311.14) provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the characteristics of the engagement that define its scope.

b. Ascertained the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the important factors that will determine the focus of the audit team’s efforts.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be required. Step c. is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level.

The overall audit strategy includes and is significantly influenced by the auditor’s judgments about materiality and the risks of material misstatement at the financial statement level. Important aspects of overall audit strategy that determine the focus of the audit team’s efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Preliminary identification of material account balances.
- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risk of material misstatement at the overall financial statement level.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having a higher risk of material misstatement.
- Determination of the extent of involvement of professionals possessing specialized skills.
- Additional emphasis on the use of professional skepticism.


- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the financial statement date rather than at an interim date.

- Identification of recent significant developments affecting the plan, the employee benefit plan industry, the plan’s financial reporting, or its legal or economic environment.

- Determination of areas where client assistance is expected to be minimal.

In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the plan and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or other auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

**Communicating with Those Charged with Governance.** The auditor may discuss elements of the overall audit strategy with those charged with governance. SAS No. 114 (AU 380) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures. According to AEBP, Paragraph 5.06, “for a single-employer employee benefit plan the individual charged with governance may include the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the employee benefit committee, administrative committee, investment committee, plan administrator or responsible party. For a multi-employer plan those charged with governance will ordinarily be the board of trustees.”

**Documentation.** Establishing the overall audit strategy need not be complex or time consuming. Professional standards do not require that a separate audit strategy memorandum be prepared to document all matters that affect audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the plan and its environment, and there is no need for a separate memorandum.

Although professional standards do not require documentation of the audit strategy itself, they do require documentation of any significant revisions to the overall audit strategy to respond to changes in circumstances. However, SAS No. 108 (AU 311.18) observes that a brief memorandum prepared at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, can be updated and changed in the current period to provide a basis for planning the current audit. The update can be based on discussions with the plan administrator.

**USE OF A SPECIALIST**

During planning, the auditor should determine whether it will be necessary to use the work of an actuary or other specialist. SAS No. 73 (AU 336), *Using the Work of a Specialist*, applies if the client engages a specialist to prepare amounts or disclosures in the financial statements or if the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared. Both circumstances are relatively common for an employee benefit plan. The plan administrator of a defined benefit retirement plan normally engages an actuary to prepare the actuarial present value of benefit obligations for financial statement presentation. Some health and welfare plans and defined benefit retirement plans also use an actuary to determine contribution rates or benefit obligations. The IRC requires independent appraisals of certain employer securities acquired by an ESOP. Also, if a plan has significant investments in restricted securities or other assets without a ready market value, the auditor
may decide it is necessary to use the work of an appraiser to examine management’s valuation. AEBP, Paragraph 7.16a, discusses the use of a specialist in determining the fair value of derivatives and other high-risk investments.

In some cases, a CPA firm may provide actuarial services to a plan audit client. AICPA independence rules currently allow a firm to provide some actuarial and audit services to a client provided certain requirements are met. The auditor should note that SAS No. 73 (AU 336) does apply when plan management engages an actuary employed by the auditor’s firm to provide actuarial services and the auditor uses the actuary’s work in evaluating material financial statement assertions. This means that if the auditor’s firm provides actuarial services to the client, the auditor should subject the actuary’s work to the same procedures as would be used for any other actuary.

SAS No. 73 does not apply to specialists employed by the auditor’s firm who are participating in the audit. For instance, if the auditor’s firm employs an appraiser and uses that appraiser as part of the audit team to evaluate fair values of investments, then SAS No. 73 does not apply. SAS No. 108 (AU 311), Planning and Supervision, applies in that situation and the specialist requires the same supervision and review as any member of the engagement team. Also, if the auditor uses an IT specialist as part of the audit team to help determine the effect of information technology on the audit, understand the plan’s controls, or design and perform tests of controls (when applicable) and substantive tests, SAS No. 108, rather than SAS No. 73, applies to the work of that specialist.

Whether the work of the specialist is subject to SAS No. 108 or SAS No. 73, the auditor is required to have sufficient knowledge of the audit issues that will involve the use of the specialist. AEBP Paragraph 5.25, indicates that this knowledge should allow the auditor to adequately communicate the objectives of the specialist’s work, to evaluate whether that work will be sufficient for the related audit objectives, and to evaluate the results of the work of the specialist.

The procedures the auditor may apply when a defined benefit retirement or health and welfare plan engages an actuary to prepare the actuarial present value of benefit obligations are as follows:

a. Inquire about the actuary’s qualifications, reputation, and relationship to the client. According to AEBP, Paragraph 10.29a, the following factors should be considered:

   (1) Whether the actuary is an “enrolled actuary” under ERISA.

   (2) The actuary’s membership in a recognized professional organization.

   (3) The opinion of other actuaries known to the auditor.

   (4) The actuary’s prior experience working on employee benefit matters. (Footnote 4 to AEBP, Paragraph 10.29a, cautions that some actuaries concentrate in areas other than pension matters, and that qualification to practice in another area does not necessarily mean qualification in the pension area.)

b. Reach and document an understanding with the client and the actuary about the nature of the actuary’s work, including:

   (1) The objectives and scope of the actuary’s work.

   (2) The methods and assumptions.

   (3) A comparison of the methods and assumptions with those used in the preceding period.

   (4) The actuary’s understanding of the auditor’s corroborative use of the actuary’s findings in relation to the representations in the financial statements.

   (5) The form and content of the actuary’s report that would enable the auditor to evaluate whether the actuary’s findings are suitable for corroborating the financial statement representations and to support them.
c. Consider the actuary’s relation to the client. The auditor should attempt to use an actuary unrelated to the client. SAS No. 73 indicates that the work of a specialist having no relationship with the plan will provide the auditor with a greater degree of reliability than the work of a specialist who is related to the plan.

(1) An actuary may perform actuarial valuations on behalf of plan participants or the plan sponsor. AEBP, Paragraph 10.29d, states that such a relationship does not ordinarily impair the actuary’s objectivity.

(2) If the actuary is related, and the auditor believes the relationship might impair the actuary’s objectivity, the auditor (or a second, unrelated, actuary) should apply additional procedures to some or all of the actuary’s assumptions, methods, or findings to determine that the findings are not unreasonable.

d. Test the reliability and completeness of census data provided by the plan and used by the actuary in the actuarial valuation. (The auditor may coordinate these procedures with procedures to be applied to plan contributions and participant data.)

e. Consider whether the actuary’s findings support the related representations in the financial statements.

f. Consider including a representation in the management representation letter for the plan to assume responsibility for the actuary’s findings. (This consideration is based on guidance presented in the AICPA’s Practice Alert 2002-02.)

As stated above, the auditor may evaluate whether the actuary’s findings support the related financial statement representations. AEBP, Paragraph 10.29b, suggests for defined benefit plans the auditor ascertain whether the method and assumptions used in the accumulated plan benefit information are in conformity with FASB Statement No. 35 (FASB ASC 960) and whether the funding method and assumptions are in accordance with ERISA.” The auditor may consider inquiring about whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations, for example, whether amounts contributed by employees and earnings thereon are properly included as vested benefits.

The auditor should document the inquiries made of the actuary and the information obtained. AEBP, Paragraph 10.30, states that “the auditor may ask the plan administrator to send a letter to the plan’s actuary requesting that the actuary (a) provide the auditor with a copy of the actuarial report, Schedule MB or SB of Form 5500, or comparable information or (b) confirm to the auditor the actuarial information that has already been obtained from the plan in connection with the audit.” AEBP, Paragraph 10.29f, states that the auditor may consider “confirming aggregate participant data used in the actuarial valuation” and suggests that this request be combined with the audit inquiry letter to the plan’s actuary referred to above.

In those cases in which the actuary’s findings differ materially from the amounts or disclosures in the financial statements, or if the actuary’s assumptions or findings appear to be unreasonable, the auditor should apply additional procedures. Normally, the auditor engages another actuary to perform these additional procedures. If the matter cannot be resolved, the auditor may need to issue a qualification or disclaimer of opinion.

SAS No. 73 (AU 336) states that the auditor’s report should not refer to the work or findings of a specialist except when the auditor, as a result of the report or findings of the specialist, makes a decision to add explanatory language to his or her standard report or depart from an unqualified opinion. It is believed such references to the work or findings of an actuary in the auditor’s report should be rare.

Although the preceding paragraphs refer to using the work of an actuary, essentially the same considerations apply to using the work of any specialist the client engages to prepare amounts or disclosures that are material to the financial statements or to a specialist the auditor engages to assist in corroborating an amount or disclosure, for example, an appraiser or computer specialist.

Planning Considerations When Specialists Are Not Used

Health and welfare benefit plans are required by GAAP to provide certain disclosures including the actuarial present value (as applicable) of claims payable, premiums due under insurance arrangements, claims incurred but not reported, accumulated eligibility credits, postretirement benefits, postemployment benefits, and changes
therein, for the period. The calculation of some of these obligations requires the assistance of an actuary. The auditor should determine in the planning process if the plan intends to engage an actuary and make required note disclosures. Health and welfare plans may consider not making these required disclosures for postretirement benefits, or for claims incurred but not reported because involvement of an actuary is generally required for the determination of these benefit obligations. As an alternative, plans may make the required disclosures based on estimates developed by management of the plan. If the plan does not make the required disclosures, or the disclosures are materially inadequate, the auditor generally should express a qualified or adverse opinion due to the material departure from GAAP.

If the plan makes required benefit obligation disclosures based on estimates made by plan management, without the use of an actuary, the auditor should consider the need to consult an actuary in evaluating the reasonableness of the estimates. When the auditor decides to consult an actuary as a specialist, and the plan refuses to provide the data necessary for the actuary to complete his or her work, the auditor’s opinion should be modified for a scope limitation.

**TIMING AND COORDINATION CONSIDERATIONS**

Because of the many interrelationships of a plan’s financial statements and activities with other entities, for example, the sponsor, trustees, or insurance companies, the auditor should give careful consideration to timing and coordination of procedures and audit areas in scheduling fieldwork.

**Audit of Plan Sponsor**

If the plan auditor also audits the sponsor’s financial statements, efficiencies can be achieved by coordinating audit procedures for employee benefit costs in the sponsor’s financial statements and benefit obligation information in the plan’s financial statements. One example is coordination of audit procedures for payroll and participant data. If the audit of the plan sponsor’s payroll expense includes selection and testing of individual payroll transactions, the auditor may expand the test to include testing of additional participant data related to accumulated plan benefits, such as hire date, age, sex, etc. Another example is coordination of audit procedures for the sponsor’s contribution with testing of the plan’s contributions received and receivable, such as tracing contribution amounts to the resolutions in the minutes of meetings of the sponsor’s board of directors. Performance and documentation of such audit procedures need not be duplicated. The plan auditor may simply cross-reference to the relevant documentation in the other set of workpapers or include photocopied portions of those workpapers in his workpapers.

One important area for coordination is the plan benefit obligation and the sponsor’s presentation of benefit information. The auditor should consider the benefit information date used for the plan sponsor’s defined benefit retirement plan cost and the plan’s presentation of benefit obligations. SFAS No. 35 (FASB ASC 960) permits the benefit information date to be as of the beginning of the plan year, that is, the prior year end. In that case, the plan auditor should be able to make use of audited information on pension costs in the plan sponsor’s prior year end financial statements. According to FASB ASC 715 (formerly SFAS No. 87, *Employers’ Accounting for Pensions*) plan sponsors are required to measure plan assets and benefit obligations as of the date of the sponsor’s fiscal year-end balance sheet, with certain exceptions.

**Public Company Plan Sponsor.** If the plan sponsor is a public company that is required to comply with Section 404 of the Sarbanes Oxley Act, the plan auditor may be able to use the documentation and compliance work related to internal control over financial reporting of the sponsor or its auditors. The plan auditor may be able to rely on key controls tested by the auditor or the sponsor or the sponsor’s internal auditor. For example, tests of controls and control documentation in the payroll area may be useful to the plan auditor in reducing the scope of testing.

**Service Organization Report**

The auditor may conclude that he will need the report of another auditor on the internal control of a service organization. In that case, the timing of audit procedures for the areas to which the service auditor’s SAS 70 report is relevant will be dependent on receipt of the report. Thus, the auditor will need to request the report on a timely basis and coordinate the performance or procedures. Also, the auditor should consider whether the time period covered by the service auditor’s SAS 70 report is suitable, considering the period covered by the plan’s financial
statements. In those cases in which the auditor plans to request that the service auditor be engaged to apply specific procedures, the request should be made to the service organization by the plan administrator on a timely basis and the work should be coordinated.

Financial Statements of Trustees or Insurance Companies

The auditor may need to obtain the audited financial statements of trustees or insurance companies holding plan assets or with which the plan has insurance or investment contracts. The auditor should determine whether such financial statements are necessary and make the request on a timely basis. Audit areas in which audited financial statements of trustees or insurance companies may be considered to be necessary include the following:

- In considering the financial capability of trustees holding plan investment assets.
- In examining units of participation in common/collective trusts or master trusts.
- In considering the financial capability of insurance companies with which the plan has guaranteed investment contracts (GICs), deposit administration (DA), or immediate participation guarantee (IPG) contracts.
- In examining plan investments in insurance separate accounts.

Multiemployer Plans

It may be necessary for the auditor of a multiemployer plan to apply procedures to contribution and participant data records at several employers or to rely on employers’ auditors to apply such procedures. The auditor should consider the need to apply audit procedures at employers participating in a multiemployer plan and coordinate the timing of the work. The auditor should either make arrangements to visit participating employers or request the other auditors to apply the procedures and report on the results.

Reading Form 5500

AEBP, Paragraph 12.32, states that other information in Form 5500 may be relevant to the audit or to the continuing propriety of the auditor’s report. It indicates the auditor should read Form 5500 and consider whether the other information in it is materially inconsistent with information in the audited financial statements or contains a material misstatement of fact. While there is no GAAS requirement to read the Form 5500 before the audit report is released (for example, when someone other than the auditor is preparing the Form 5500 and it has not yet been prepared), it is suggested that release of the audit report be delayed until the Form 5500 is available and has been read. If differences between Form 5500 and the financial statements arise, the auditor should consider performing additional procedures. If the auditor’s report has already been issued, the auditor should consider the possibility of reissuing the auditor’s report for the reconciling items. The filing deadline for Form 5500 is from seven to nine and one-half months after the plan’s year end. The auditor should keep this timing in mind when scheduling fieldwork and estimating the report delivery date.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. According to SAS No. 107 (AU 312.30), once materiality is established, the auditor should do which of the following?
   a. Consider materiality when planning and evaluating differently depending on the inherent business characteristics of the entity being audited.
   b. Consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited.

31. A planning materiality benchmark is used primarily for which of the following purposes?
   a. To plan the extent of audit testing.
   b. To provide a basis for determining the adequacy of the nature and timing of procedures.
   c. To predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit.

32. Control Risk (CR) is one component of audit risk and is defined as:
   a. The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the plan’s internal control.
   b. The risk that the auditor’s procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.
   c. The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

33. When the auditor quantifies the components as a percentage of the components of the risk model, the judgment is:
   a. Subjective.
   b. Mathematical calculation.

34. The auditor may discuss which of the following audit matters with those charged with governance?
   a. The timing of audit procedures.
   b. The overall audit strategy.

35. SAS No. 73 (AU 336), Using the Work of a Specialist, does not apply in which of the following circumstances?
   a. If the client engages a specialist to prepare amounts or disclosures in the financial statements.
   b. If the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared.
   c. If the auditor uses the work of an independent appraiser to check management’s valuation of assets without a ready market value.
   d. If the auditor’s firm employs an appraiser and uses that appraiser as part of the audit team to evaluate fair values of investments.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

30. According to SAS No. 107 (AU 312.30), once materiality is established, the auditor should do which of the following? (Page 100)

   a. Consider materiality when planning and evaluating differently depending on the inherent business characteristics of the entity being audited. [This answer is incorrect. SAS No. 107 (AU 312.30) is clear that materiality should not be considered differently no matter the inherent business characteristics of the entity being audited.]

   b. Consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited. [This answer is correct. Once materiality is established, SAS No. 107 (AU 312.30) indicates that the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited. For audit purposes, a high degree of measurement uncertainty does not cause the auditor to follow different judgments than those applicable to other plans.]

31. A planning materiality benchmark is used primarily for which of the following purposes? (Page 101)

   a. To plan the extent of audit testing. [This answer is correct. There may be other uses for a planning materiality benchmark, but it is primarily used to plan the extent of audit testing since a lower threshold would require more testing.]

   b. To provide a basis for determining the adequacy of the nature and timing of procedures. [This answer is incorrect. A planning materiality benchmark does not necessarily claim to provide a basis for determining the adequacy of other aspects of audit planning; specifically, the nature and timing of procedures.]

   c. To predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit. [This answer is incorrect. The choice of a benchmark for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit. This cannot be determined until the audit is conducted.]

32. Control Risk (CR) is one component of audit risk and is defined as: (Page 104)

   a. The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the plan’s internal control. [This answer is correct. This is the correct definition of Control Risk (CR), one of three components of audit risk.]

   b. The risk that the auditor’s procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. [This answer is incorrect. This definition relates to Detection Risk (DR), another component of audit risk.]

   c. The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. [This answer is incorrect. This definition relates to Inherent Risk (IR), another component of audit risk.]

33. When the auditor quantifies the components as a percentage of the components of the risk model, the judgment is: (Page 105)

   a. Subjective. [This answer is correct. The auditor’s quantification of the components of the risk model is always made subjectively and is a judgment rather than a precise measurement of risk.]

   b. Mathematical calculation. [This answer is incorrect. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation. It is not a precise measurement of risk.]
34. The auditor may discuss which of the following audit matters with those charged with governance? (Page 111)

a. The timing of audit procedures. [This answer is incorrect. Although the auditor must communicate to those charged with governance the planned scope and timing of the audit, the auditor should avoid discussing the detailed nature and timing of audit procedures so as not to compromise the effectiveness of the audit.]

b. The overall audit strategy. [This answer is correct. Discussing elements of the overall audit strategy with those charged with governance will not compromise the effectiveness of the audit and is required by SAS No. 114.]

35. SAS No. 73 (AU 336), Using the Work of a Specialist, does not apply in which of the following circumstances? (Page 112)

a. If the client engages a specialist to prepare amounts or disclosures in the financial statements. [This answer is incorrect. SAS No. 73 (AU 336) applies if the client engages a specialist to prepare amounts or disclosures in the financial statements.]

b. If the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared. [This answer is incorrect. SAS No. 73 (AU 336) applies if the auditor decides to use a specialist in auditing a financial statement amount or disclosure that management prepared.]

c. If the auditor uses the work of an independent appraiser to check management’s valuation of assets without a ready market value. [This answer is incorrect. If a plan has significant investments in restricted securities or other assets without a ready market value, the auditor may decide it is necessary to use the work of an appraiser to examine management’s valuation and SAS No. 73 (AU 336) would apply.]

d. If the auditor’s firm employs an appraiser and uses that appraiser as part of the audit team to evaluate fair values of investments. [This answer is correct. SAS No. 73 does not apply to specialists employed by the auditor’s firm who are participating in the audit. SAS No. 108 (AU 311), Planning and Supervision, applies in that situation and the specialist requires the same supervision and review as any member of the engagement team.]
AUDIT SAMPLING

SAS No. 39 (AU 350), *Audit Sampling*, as amended, observes that the basic concept of sampling is well established in auditing practice and imposes several specific requirements for the planning, selection, performance, and evaluation of audit samples. In addition, the AICPA Audit and Accounting Guide, *Audit Sampling*, explains how to apply SAS No. 39. SAS No. 39 at AU 350.01 defines audit sampling as “the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.” Many audit procedures involve application to less than 100% of the items in a balance or class, but do not involve audit sampling. For example, a walkthrough of the processing of benefit payments to obtain an understanding of the financial reporting system and testing the details of all investment transactions above a specified cutoff dollar amount are not audit sampling. Thus, the key distinguishing feature for identifying an audit sampling application is deciding whether the purpose of the procedure is to project a characteristic of the items tested to the balance or class from which the items were selected.

**Determining Audit Sampling Applications**

Because the auditor usually has several alternatives in designing the mix of audit procedures to be applied to a particular account balance or transaction class, the auditor may design a particular procedure as a sampling or a nonsampling application based primarily on considerations of audit efficiency. Generally, sampling will be more efficient in an employee benefit plan engagement when the audit area is a critical area based on consideration of audit risk and materiality, the volume of transactions is relatively high, and individual items within the balance or class do not differ significantly in dollar amount or the details of processing. In many cases, one of these features will tip the scales for or against designing the procedure as a sampling application.

In many instances the auditor may rely on procedures performed in prior audits thereby reducing the number of transactions or data that needs further testing in the current year. For example, much of the participant data (such as date of birth and hire date) does not change. In some instances, the benefit payments do not change. In some cases, the auditor can simply compare the information for the current year to the prior year and apply procedures to some or all of the changes. In these circumstances, the auditor should apply procedures to determine that the listings are complete and accurate as to the number of participants; that is, new participants that are added and those that are deleted.

One important feature in deciding whether to use sampling is the size of the population. Consider the following situation:

**Example 3-1: An example of a nonsampling application.**

The Woodsman Quarry employs about 125 operating and clerical personnel. Woodsman has been in business for more than 40 years, but the pension plan is relatively new and the workforce is relatively young. Only 12 former employees are receiving benefit payments. This is the first audit of the plan. Should the auditor sample benefit payments? The small size of the population dictates that audit procedures in the benefits area be designed as a nonsampling application. The auditor obtains a schedule of benefits by participant and scans it for reasonableness. (Based on an understanding of the plan and the sponsor, the auditor has an idea as to what the range of the benefits should be.) By inquiry, observation, and inspection of plan documents, the auditor determines the controls relating to benefit payment elections and benefit disbursements. The auditor checks four or five of the benefit amounts, checks eligibility, and examines the benefit election forms. The auditor may decide to confirm the largest two or three benefit payments with the former employees and compare the signatures on the returned confirmations with the employee signatures on the benefit payment election forms. The auditor notes the agreement of the payments with the form of payment requested and other details such as hire date. The auditor concludes that his procedures corroborate his understanding of the controls for determining employee eligibility and the form and amount of payment.

In subsequent years, the auditor may obtain a comparative schedule of benefits by participant and review the propriety of changes from the amounts paid in the prior year. For example, the auditor may check the benefit amount, eligibility, and benefit election forms for all or selected new retirees. The auditor may also confirm selected benefit amounts or perform other procedures as a test for retirees who should no longer be receiving benefits.
Even though the auditor has tested less than all the benefit payments, this is not an audit sampling application. This result is due primarily to the auditor’s approach rather than the inherent characteristics of the audit procedures. In other words, confirmation of less than all the benefit payments is not considered a sampling application in this circumstance because of the way the auditor defined the objective of the test. Confirmation of benefit payments might also be a sampling application when the volume of payments is high and the auditor’s conclusion depends on projecting the results concerning the accuracy of payments confirmed to the entire amount of benefit payments.

**Likelihood of Using Audit Sampling by Audit Area.** Considering the normal characteristics of the various audit areas of employee benefit plans, it is possible to generalize about the likelihood of audit sampling. Exhibit 3-2 presents conclusions about the likelihood of using audit sampling in the typical audit areas of an employee benefit plan. This exhibit also includes an indication of the type of sampling that is likely to be used as either balance testing or transaction testing.

### Exhibit 3-2

<table>
<thead>
<tr>
<th>Audit Area</th>
<th>Likelihood of Audit Sampling</th>
<th>Type of Sampling Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer Contributions Received and Receivable(^a)</td>
<td>Rare</td>
<td>Balance</td>
</tr>
<tr>
<td>Investments and Related Income(^b)</td>
<td>Rare to Moderate</td>
<td>Balance or Transaction Testing</td>
</tr>
<tr>
<td>Contracts with Insurance Companies</td>
<td>Rare</td>
<td>Balance</td>
</tr>
<tr>
<td>Participant Data and Employee Contributions</td>
<td>Likely</td>
<td>Transaction Testing</td>
</tr>
<tr>
<td>Benefit Payments</td>
<td>Moderate</td>
<td>Balance or Transaction Testing</td>
</tr>
<tr>
<td>Benefit Obligations</td>
<td>Rare</td>
<td>Balance or Transaction Testing</td>
</tr>
<tr>
<td>Other Assets, Liabilities, and Operating Expenses</td>
<td>Rare</td>
<td>Balance or Transaction Testing</td>
</tr>
</tbody>
</table>

**Notes:**

\(^a\) For a multiemployer plan, there is a moderate likelihood of sampling of employer contributions.

\(^b\) For a situation where investment transactions are numerous and there is no trustee, sampling of investment transactions would be likely.

* * *

The most likely areas for use of audit sampling in a benefit plan audit are participant data and employee contributions. An important reason for this is that the volume of items is more likely to be relatively high. Also, the nature and objectives of the audit procedures applied in this area are readily susceptible to being efficiently designed as audit sampling applications. Generally, the audit procedures are applied to employer payroll and personnel records. The auditor selects individual payroll transactions and tests the details for accuracy of pay rate, hours, computations, and demographic data such as birth and hire dates, sex, termination date, etc. Tests of employee eligibility and employee contributions can be readily applied to the same selection of payroll transactions. The same is generally true for tests of withdrawals and terminations, but more items may have to be selected if there are insufficient withdrawals and terminations in the individual payroll transactions. For example, the auditor may select more items if the original selection does not include at least five withdrawals or terminations.
Use of audit sampling for benefit payments is moderately likely. The likelihood is heavily dependent on the volume of benefit payments. Normally there are far fewer people receiving benefits than are currently employed. Thus, the likelihood of using sampling is less than for participant data. The primary audit procedures in the benefit payments area involve testing payments to selected recipients for eligibility and accuracy of method and amount of payment. When sampling is used, the auditor should consider whether the sample includes a sufficient number of employees who retired in the current year, for example, at least five current retirees unless the number of retirees is too small for this to be practical.

Investments is always an important audit area in an employee benefit plan engagement, but the likelihood of sampling depends on the number of individual investment balances and the volume of individual investment transactions. Generally, for investment balances, the most efficient and effective approach is to select all items above an established cutoff amount for substantive testing, that is, for confirmation, physical examination, etc. In these circumstances, it is advisable to vary the cutoff amount and to scan items below that amount. Sampling is rarely used except for those engagements in which the dollar amount and number of individual investments after testing individually significant items is relatively large. However, the auditor also has to consider the need to test individual investment transactions. When investments are nontrusted or are held in a nondiscretionary trust, and trading activity is relatively high, the auditor should select a sample of individual transactions and test the details for authorization and proper accounting, including use of the trade date to record purchases and sales. When investments are held in a discretionary trust, the plan auditor usually cannot examine transactions but relies on a service auditor’s SAS 70 report.

In other benefit plan audit areas, use of audit sampling is relatively rare. For employer contributions received and receivable, contracts with insurance companies, and benefit obligations, the auditor normally takes a primarily substantive approach and frequently can confirm aggregate amounts with another party. However, for a defined contribution plan, the auditor may test individual participant accounts using audit sampling, depending on the number of participants and the complexity of investment medium elections. Also, for a multiemployer plan, sampling of employer contributions is more likely. For other assets, liabilities, and operating expenses the balances and level of activity are normally relatively small and use of sampling is relatively rare. In many cases, the plan sponsor absorbs most operating expenses, and account balances in this area are negligible.

**Sampling Approaches and Methods**

SAS No. 39 (AU 350) discusses audit sampling in two categories—sampling in tests of details and sampling in tests of controls. Although SAS No. 39 applies equally to statistical and nonstatistical sampling and uses audit rather than statistical terminology, it is helpful to recognize that sampling for tests of details corresponds to the statistical method known as variables sampling, including monetary unit sampling (MUS) (also called probability-proportional-to-size sampling or PPS), and that sampling for tests of controls corresponds to attribute sampling. This correspondence of approaches is worth noting because in practice the attribute sampling approach is efficient and effective to use for transaction testing, which may include both substantive and control aspects (a dual-purpose test). That is, attribute sampling can be used to test the accuracy of recording transactions as to account, amount, and period as well as the effective performance of controls related to approvals and recomputation. For this reason, the discussion in this section is divided into two basic types of sampling referred to as balance testing and transaction testing.

**Balance Testing.** As explained in SAS No. 39 (AU 350), a test of details using audit sampling, referred to here as balance testing, involves evaluation of the results of the sample in monetary terms. In planning this type of sample, the auditor considers how much monetary misstatement in the related account balance may exist without causing the financial statements to be materially misstated (tolerable misstatement) and the allowable risk of incorrectly accepting a balance misstated by that amount. In evaluating sample results for this type of sample, the auditor normally considers the upper dollar limit on the amount of misstatement of the balance at the planned allowable risk of incorrect acceptance. When statistical sampling is used, both the dollar amount of misstatement and the effect of the sampling risk are quantified. When nonstatistical sampling is used, dollar amounts can be quantified, but the effect of sampling risk can only be approximated and considered in qualitative terms.

**Transaction Testing.** Transaction testing using audit sampling ordinarily takes the form of what was once called a dual-purpose test because it is directed to both the accounting accuracy of transaction processing and the
operating effectiveness of related internal controls. SAS No. 39, as amended, at AU 350.44 states that “... the auditor may design a sample that will be used for dual purposes: testing the operating effectiveness of an identified control and testing whether the recorded monetary amount of transactions is correct.” The correctness of the monetary amount usually includes whether the transaction is recorded correctly as to account, amount, and period. The auditor also ordinarily tests transaction details for compliance with plan requirements and controls, for example, whether participant eligibility has been approved and whether the participant meets plan requirements for eligibility.

Although the auditor is concerned with certain substantive aspects of transactions in this type of testing, the sampling approach used is analogous to attribute sampling rather than variables sampling. The primary distinction is that the auditor’s planning and evaluation of the sample is focused on the rate rather than the monetary amount of misstatement. For this approach to be appropriate, all transactions in the class from which the sample is selected should be processed through the same financial reporting system and the likelihood of a mistake being made in processing a particular transaction should be independent of its dollar amount.

**Designing Tests of Transactions Using Audit Sampling**

SAS No. 39 (AU 350.31–43), as amended, establishes requirements for the planning, selection, performance, and evaluation of sampling in tests of transactions. An efficient nonstatistical sampling approach has been developed that meets these requirements that approximates a statistical attribute sampling method that is sometimes referred to as stop-or-go sampling.

**Planning.** Two basic conditions for using this approach are (a) that the audit procedure being applied using sampling is not the only procedure that contributes to the objective of the test and (b) a relatively low rate of processing mistakes is expected. These conditions are intended to compensate for the fact that judgments about sample size and sample results using this approach are approximations rather than exact statistical computations. Normally, using this approach, the auditor need only make a choice between a sample size of 60 and a sample size of 25. A sample of 25 with no misstatements or deviations would approximate an upper limit on the rate of misstatement of 10% and allowable sampling risk of 10%. A sample of 60 with no misstatements or deviations would approximate an upper limit rate of 5% and a sampling risk of 5%.

The basic condition that requires that there be other audit procedures that contribute to the same objective as the procedure being applied using sampling is normally satisfied by performing analytical procedures. For example, scanning a comparative schedule of benefit payments for reasonableness in light of the number of participants eligible to receive benefits in both periods.

The condition that permits a sample of 25 rather than 60 is that, based on the auditor’s understanding of internal control, there are controls that are pertinent to the aspects of transaction processing being tested that appear to be effective and that are being tested simultaneously.

**Sample Selection.** SAS No. 39 (AU 350), as amended, requires a “representative sample” for audit sampling applications. This means that the items must be selected in such a manner that all items have an opportunity to be selected. Among the methods that meet this requirement are simple random selection using random numbers, systematic selection (every nth item), or haphazard selection. The first two methods are explained in detail in sampling textbooks and the AICPA Audit and Accounting Guide, *Audit Sampling*. The concept of haphazard selection is explained in *Audit Sampling* as selecting in no specific pattern without bias for or against any items in the population. In other words, to achieve haphazard selection, the auditor’s selection should not be influenced by the size, location, or appearance of the item.

Whenever practical, the auditor should use random selection (with computer-generated random numbers or a random number table) or systematic selection with a random start. Using these approaches does not make the audit sampling application a statistical sample. Haphazard selection may be used when the population is not numbered or when other circumstances make use of one of the other methods impractical. Using computer-generated random numbers is recommended because it is more efficient than using a table. Several templates for software packages are available, including PPC’s *Workpapers for Employee Benefit Plan Audits*.

**Evaluation.** The evaluation of sample results for the transaction testing approach differs for a sample size of 25 versus a size of 60. The sample size of 25 is used when the auditor is simultaneously testing internal controls that
help ensure accounting accuracy or compliance with plan and ERISA requirements. The auditor should identify and test only those controls that are pertinent to these matters and that would make a difference to the auditor’s control risk assessment. To support an assessment of control risk below the maximum, the sample results for a sample of 25 should contain no deviations from the identified controls. In qualitative terms, no deviations in a sample of 25 may be interpreted as a moderate level of control risk. For this reason and for reasons of efficiency, the auditor should not identify and test control activities that would not change the control risk assessment, and any deviations from unimportant controls that turn up in sample results should be ignored. Generally, a mistake in accounting processing, that is, recording in the wrong account, amount, or period, should be treated in the same manner as a deviation from internal controls. The reason for this is that a misstatement can usually be traced to a deficiency in the system. However, it is always important to make a qualitative analysis of the nature and cause of the misstatement. The auditor needs a good understanding of the cause of the misstatement to consider what steps should be taken to help ensure that there is not an unacceptable risk that similar misstatements could accumulate to a material amount. In the rare case when a misstatement is an isolated instance and there are no indications of a deficiency in controls, the auditor need not change the control risk assessment. However, most misstatements are not isolated incidents, and the auditor should make this judgment carefully. For example, a keying error not detected by the system is a deficiency in the system and not an isolated incident simply because it occurred randomly.

When the auditor has initially selected a sample of 25 and sample results include one deviation from controls that are important to the control risk assessment, the sample size for the test should be expanded to 60. The reason for this is that a sample size as small as 25 to assess accounting accuracy is only appropriate when control risk can be assessed below the maximum level. When sample results do not support a control risk assessment below the maximum, expanded testing of accounting accuracy is necessary.

When the auditor has initially selected a sample of 60 or expanded the sample size to 60, the focus of the evaluation shifts primarily to a qualitative analysis of the nature and cause of any misstatements detected. Based on the understanding obtained of why the misstatements occurred, the auditor must assess whether there is an unacceptable risk of similar misstatements accumulating to a material amount. This type of analysis requires a good understanding of the client and its industry and internal control. No quantitative analysis can substitute for a seasoned qualitative assessment of the nature and cause of misstatement and the steps that should be taken in the particular case to detect additional misstatements if they exist. In this regard, SAS No. 107, (AU 312.46) advises the following steps in communicating detected misstatements to management:

Where the auditor evaluates the amount as likely misstatement from a sample class of transactions . . . as material, either individually or in the aggregate with other misstatements, the auditor should request management to examine the class of transactions . . . in order to identify and correct misstatements therein.

**DETAILED AUDIT PLANS AND WORKPAPERS—ORGANIZATION AND STRUCTURE**

SAS No. 108 (AU 311.19–.20) states that “the auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.”

As part of developing the overall audit strategy, the auditor will ordinarily have identified material account balances and audit areas where there may be higher risks of material misstatement. SAS No. 108 (AU 311.17) notes that “once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor’s resources.” The audit plan is commonly referred to as the audit program.
Determining the Audit Approach

The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. The auditor identifies risks (including risks of material misstatement due to fraud), considers management’s response to those risks through operating decisions and controls, and assesses the risk of material misstatement at the relevant assertion level. Based on that risk assessment, the auditor determines what audit procedures need to be performed.

**Limited Procedures Approach.** The auditor should first consider whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures approach and will generally be appropriate only for audit areas that are not significant and have a low combined risk of material misstatement. For audit areas that are not significant but have a risk of material misstatement other than low or require audit attention for other reasons such as client or regulatory expectations, an audit program might be needed. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

**Basic and Extended Approaches.** The PPC audit programs include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the audit programs for individual audit areas include the following sections:

- **Basic Procedures**, which include a combination of substantive analytical procedures and tests of details.
- **Extended Procedures (Procedures for Additional Assurance)**, which include procedures from which the auditor can choose one or more steps as necessary to supplement the basic procedures in response to the auditor’s risk assessment at the relevant assertion level.
- **Other Audit Procedures**, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other audit procedures are considered Extended Procedures when completing the “Risk Assessment Summary Form.”)

Auditors should decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. However, the analysis is not a simple determination based on whether that risk is high, moderate, or low. Usually, a low or moderate risk of material misstatement in a significant audit area means that a Basic Procedures approach is appropriate for those assertions. However, the auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks. The particular tests selected, whether basic or extended, should be tailored to the nature, cause, and direction of expected potential misstatements at the relevant assertion level.

As previously stated, the Basic Procedures section of the audit programs contains certain tests of details, many of which are required by auditing standards or considered relevant by AEBP. If applicable, the auditor should perform those procedures. The performance of those procedures may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the audit programs, which includes procedures for additional assurance, is a source list of possible audit procedures. It is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The auditor selects procedures from the list that are needed to respond to the risk assessment. The selection of extended additional assurance procedures needed to address a particular risk is a matter of auditor judgment. Particularly in audits of employee benefit plans, if the auditor has a higher level of assessed risk and wants to perform extended procedures, he may want to consider extending the level of detail testing performed in the Basic Procedures section of the audit program.
Audit Documentation (Workpapers)

SAS No. 103 (AU 339), Audit Documentation, requires the auditor to prepare and retain workpapers, addresses the form, content, and extent of audit documentation, and specifies requirements for revisions made to documentation after the date of the auditor’s report. The main purpose of workpapers, as identified in SAS No. 103 (AU 339.03), is to provide the principal support for the auditor’s report that includes:

- The representation that the audit was performed in accordance with generally accepted auditing standards
- The opinion expressed (or disclaimed) on the financial statements.

In addition to this primary purpose, audit documentation can be used for a variety of other purposes. These additional purposes are discussed below.

Support for Auditor’s Report. Auditors must prepare audit documentation with an appropriate amount of detail that provides a clear understanding of the work performed, the evidence obtained along with its source, and the conclusions reached. The need to use workpapers to support the audit report only arises if the quality of the audit is questioned, e.g., in a EBSA review of audit workpapers. SAS No. 103 emphasizes that audit documentation is a critical component of audit quality. An auditor’s defense, however, may not be entirely limited to what is in the workpapers. The workpapers are the principal record of the work done and conclusions reached, but an auditor, in defending the quality of the audit, might supplement the audit documentation by other means. According to SAS No. 103 (AU 339.11):

Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached but may be used by the auditor to clarify or explain information contained in the audit documentation. It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

While an auditor will not document every consideration made during the course of the audit, care should be taken to ensure that the audit documentation meets the overall requirement of providing a clear understanding of what was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained.

Auditors should be aware that certain states and regulatory agencies may have stringent requirements for audit documentation. For example, California has adopted rules applicable to both public and nonpublic company audits containing a rebuttable presumption that an audit procedure not documented was not performed. The burden of proof lies with the auditor. Recent comments by DOL officials indicate the DOL has adopted a similar approach relating to employee benefit plan audits. The presumption can be overcome by a preponderance of the evidence, which ordinarily requires more than just an oral explanation.

Other Purposes of Workpapers. While audit workpapers must achieve the primary purpose noted above, audit documentation that is thoroughly prepared with a sufficient amount of detail can be useful for a number of purposes. In fact, firms that adopt documentation policies that encourage well-designed and prepared workpapers will often achieve a higher degree of audit effectiveness and efficiency in their engagements. Some additional purposes of workpapers include:

- Aids in the planning and performance of the current and future engagements.
- Provides guidance for newer team members.
- Reinforces and demonstrates accountability.
- Aids in supervision and review.
- Aids in external review.
- Assists successor auditors in their review.
Basic Requirements for Content. An auditor has some discretion in deciding on the specific workpapers to prepare; however, SAS No. 103 provides criteria auditors can use in making documentation decisions and defines significant findings and other matters requiring documentation in the workpapers. According to SAS No. 103 (AU 339.10), workpapers should enable an experienced auditor with no previous connection to the audit to understand:

a. The nature, timing, and extent of auditing procedures performed to comply with professional standards and applicable legal or regulatory requirements.

b. The results of the audit procedures performed along with the evidence gathered.

c. The conclusions reached on significant matters.

d. That the financial statements (or other audited information) agree or reconcile to the underlying accounting records.

The use of the term experienced auditor with no previous connection with the audit reinforces a documentation concept practiced by many auditors that indicates workpapers should "stand by themselves." That is, the documentation requires little or no oral explanation as to what was done, who performed the work, and the reasons for the conclusions. The SAS considers an experienced auditor to be an individual with the necessary competency and skill to perform the audit. Such skills and competencies would include an adequate knowledge of professional standards and applicable legal or regulatory requirements, the audit process, the client’s business environment, and the audit and financial reporting issues that apply to the employee benefit plan industry.

As discussed above, there are few stringent requirements as to what should be contained in the workpapers. Accordingly, the form, content, and extent of the workpapers will be dependent on factors that are unique to the engagement. In determining the documentation appropriate for a particular engagement, auditors should consider:

a. The risk of material misstatement associated with the assertion, account balance, or class of transactions, including disclosures.

b. The nature of the auditing procedure.

c. The amount of judgment that will be necessary in carrying out the procedure and evaluating the results.

d. The significance of the audit evidence obtained to the assertion tested.

e. The nature and extent of exceptions.

f. The need to document or support a conclusion not readily apparent from the documentation of the work performed or evidence gathered.

SAS No. 103 provides the following specific audit documentation requirements:

a. Abstracts or Copies of the Client’s Records. The workpapers should include copies of the client’s records and abstracts or copies of significant contracts or agreements examined, if they are needed to allow an experienced auditor to understand the work performed and conclusions reached.

b. Identification of Items Tested. Documentation of procedures performed, including tests of controls and substantive tests of details involving inspection of documents or confirmation, should identify the items tested.

c. Individuals Performing and Reviewing the Work, and Associated Dates. When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date of the review.

d. Significant Findings or Issues. Auditors are required to document information related to significant audit findings or issues.
e. **Departures from the Requirements in the SASs.** In the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement of the SASs, documentation must be made justifying the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.

f. **Revisions after the Date of the Auditor’s Report.** Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor’s report. Revisions may be attributable to:
   - Omitted procedures that would have been considered necessary at the time of the audit.
   - Subsequent discovery of facts that existed at the date of the report.
   - Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date.

g. **Report Release Date.** The report release date should be recorded in the audit documentation.

**Documenting Specific Items Tested and Other Procedures.** Audit documentation of the procedures performed should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents or confirmation. SAS No. 103 also provides examples for documenting the identifying characteristics of inquiry and observation procedures. Therefore, it is recommended to also apply the requirement to observation procedures. For inspection of documents and confirmation procedures, it is believed items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria. For example:

- For tests of significant items, documentation may describe the auditor’s scope and the source of the items (for example, all benefit payments greater than $5,000 from the December cash disbursements records.)
- For haphazard or random samples, documentation may identify the items by their dates and specific check numbers, employee numbers, etc.
- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

For inquiry and observation procedures, the identifying characteristics may be recorded as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.
- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

When an analytical procedure is used as the principal substantive procedure for a significant financial statement assertion, SAS No. 56 (AU 329), *Analytical Procedures*, requires the auditor to document (a) the expectation and the factors considered in its development (unless readily determinable from the work performed), (b) the results of the comparison between the expectation and recorded amounts, and (c) any additional procedures performed to address significant unexplained differences and the results of those procedures. Although not required by authoritative literature, documentation might also include information about the auditor’s approach to evaluating the significance of the difference between the recorded amount and the expectation (for example, a percentage of tolerable misstatement).

**Documenting the Identification of Preparer and Reviewer.** Auditors should record who performed the audit procedures and when such work was completed. In most situations, this is a simple process; normally it only requires the individual who performed the procedure to initial and date the specific workpaper, checklist, or
program step that specifies the work performed. The checklists and audit programs included in this course provide spaces to facilitate this documentation. However, if a program step is supported by workpapers, there is no need to date both the program step and the supporting workpapers. Doing so creates the possibility of discrepancies in the dating, which should be avoided. Therefore, when completing audit program steps that are supported by workpapers, some auditors may choose to sign, but not date, such program steps because the supporting workpapers should indicate the date the procedures were performed. In such cases, it is preferable to cross-reference the program steps to the supporting workpapers.

SAS No. 103 also requires documentation of who reviewed specific audit documentation and the date of the review. The statement does not indicate the manner or form of recording the evidence of these “who and when” components of the review. However, reviewers are not required to evidence their review on each working paper. For detailed reviewers, a practical and efficient way of indicating who reviewed the audit work and when is for the reviewer to initial and date the specific workpapers reviewed. However, auditors may adopt other documentation methods to evidence this review as long as it is clear who reviewed specified elements of the work and when the review occurred. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in a memo that indicates the workpaper sections reviewed and the date(s) of their review. Checklists may also be used.

Documenting Significant Findings or Issues. On some employee benefit plan audits the engagement team may be faced with difficult issues that require significant professional judgment to resolve. Examples of significant audit findings or issues include the following:

- Significant matters involving the appropriate selection, application, and consistency of accounting principles, such as:
  - The reasonableness of significant accounting estimates and underlying assumptions.
  - The likelihood of significant contingencies occurring.
  - Complex or unusual transactions and the application of GAAP to those transactions.
- Results of procedures that indicate the financial statements or disclosures could be materially misstated.
- Results of procedures that indicate a need to revise prior assessments of the risks of material misstatement and the auditor’s responses to such risks.
- Circumstances that cause significant difficulty in applying procedures considered necessary.
- Other findings that could result in modification of the auditor’s report.
- Audit adjustments identified by the auditor, whether or not recorded by the client, that could, either individually or when aggregated with others, have a material effect on the financial statements.

SAS No. 103 requires auditors to document significant audit findings or issues such as those outlined above, actions taken and evidence obtained in addressing them, and the basis for the auditor’s conclusions.

Discussions of significant findings or issues that occur between the auditor and plan management should also be documented in a timely manner, including (a) the items discussed, (b) when and with whom they were discussed, and (c) the responses obtained. In addition, the auditor should document similar information regarding any discussions of significant findings or issues with internal or external parties other than plan management including board or audit committee members (if applicable), lower level employees, trustees, record keepers, or other third-party service providers. Minutes of meetings attended by the auditor at which these matters were discussed can satisfy this documentation requirement.

Auditors should also document how they addressed information that was contradictory or inconsistent with their final conclusion on a significant finding or issue. Such documentation might include the auditor’s procedures to address the information or consultations regarding differences in professional judgment among audit team members or between the team and others consulted.
The matters above can be documented in a memorandum. It is recommended that such a memorandum begin with a description of the facts giving rise to the issue, followed with a discussion of the factors considered and evidence gathered in formulating the conclusion. The auditor’s conclusion should be clearly stated, along with his or her reasoning process supporting the conclusion. Other items that should be documented include any discussions as noted above, the existence of conflicting evidence or guidance supporting contrary points of view, and any consultation that occurred in resolving the issue.

Documenting Revisions after the Date of the Auditor’s Report. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor should strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. Professional standards also include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor’s report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.
- The documentation completion date.

Those dates, as well as the requirements for assembling and completing the audit file and making changes to the workpapers, are discussed in the following paragraphs.

The audit report date should be the date that the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements. Typically, such evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor cannot simply use the date that the audit team left the field unless the requirements of this paragraph have been satisfied at that date.

The report release date is the date that the auditor gives the client permission to use the auditor’s report in connection with the financial statements. For most audits of employee benefit plans, this will be the date the auditor delivers the report to the client. SAS No. 103 requires the auditor to document the report release date in the workpapers. In most cases, the report release date should be close to the date of the auditor’s report. Many firms adopt a policy about when to date their auditor’s report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). A decision to redate the report should result in extending the subsequent events review to the later date. Auditors should consider covering that matter in their firm’s quality control policies and procedures.

SQCS No. 7 (QC 10.62) specifies that firms “should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released.” Those policies and procedures should comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. As stated above, completing workpapers on a timely basis as the engagement progresses is recommended. However, the final assembly and completion of the audit file should occur within 60 days of the report release date. SAS No. 103 refers to this date as the documentation completion date. After that date, the auditor must not delete or discard any documentation prior to the required five-year retention period. (ERISA requires the auditor to maintain workpapers for at least six years.) Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm’s policy of quality control. In addition, the auditor should consider whether there are regulatory or state requirements that require a shorter documentation completion period.
At any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor’s report.
- Insert information that was received after the date of the auditor’s report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor’s report and prior to the documentation completion date constitute those that are part of the “wrap-up” or workpaper filing process. The auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

When the auditor determines that it is necessary to make additions or other changes to the audit workpapers after the date of the auditor’s report for other than those activities noted above, the auditor should make changes to the audit documentation to record the performance of the new procedure or the new conclusions that were reached. In addition, the documentation of the changes should include:

- When and by whom the changes were made and, if applicable, reviewed.
- The specific reasons for the change.
- The effect of any changes on conclusions reached.

The auditor should also consider whether there are regulatory or state requirements that differ from GAAS.

**Audit Documentation Recommendations.** There are a number of practical workpaper documentation techniques that the authors recommend auditors follow, including the following:

- Always identify the individuals who performed and reviewed the audit work and the dates completed and reviewed.
- Clearly describe the purpose of the workpaper and the nature of the audit steps performed. For example, state “Examined employee payroll records and compared totals to the contribution calculation to determine the accuracy of the employee contribution calculation” rather than simply “Vouched.”
- Identify client prepared schedules, including, if applicable, the title of the report, the period covered, and the date prepared.
- Initial and cross-reference from the work program to the documentation supporting the completion of the related program step.
- Document the resolution of all significant questions and issues raised during the audit, including discussions with management and others.
- Indicate how conflicting audit evidence was resolved.

**Workpaper Indexing.** In practice, workpaper files normally fall into three categories (a) the general or administrative file, (b) the work or account balance file, and (c) the permanent file. There is a great deal of flexibility and individuality in the contents of files and the way they are indexed and cross-referenced. The most important
consideration is to use some type of well-organized, but simple, system that can be uniformly adopted on all engagements. One simple scheme is to use one folder or binder for general file items, for example, the audit planning form, planning materiality worksheet, etc., with the individual items indexed alphabetically, and a series of binders or folders for the work file. The material for each audit program area can be indexed numerically with a prefix to indicate it is a work file; for example, contributions received and receivable would be WF-1, and the workpapers within that file would be WF-1-1, WF-1-2, etc. Many auditors assign an alphabetic code to each account balance or audit program area, for example, A for contributions received and receivable, B for investments and related income, etc., and numerically index supporting schedules within each alpha code, for example, A-1, A-2, B-1, B-2, etc. These are just two possible approaches to workpaper indexing, but adoption of a simple indexing approach is encouraged. The checklists and audit programs in this course provide space at the top right corners to insert the workpaper index.

**Workpaper Considerations for an ERISA Audit.** When the engagement must meet ERISA requirements, there are several unique workpaper considerations. The DOL may decide to review the auditor’s workpapers if it concludes that there are inadequacies in the auditor’s report, financial statements, or required schedules submitted with Form 5500. Auditors should also be aware of the DOL’s position on undocumented audit procedures.

While the DOL does not have any explicit requirements for workpaper documentation more extensive than required by GAAS, the auditor should consider the increased potential for review of ERISA audit workpapers in making decisions about the extent of documentation. Such a review may be made by the DOL or by a peer reviewer. Under the AICPA peer review program, greater weight is given to selecting an ERISA audit for review if a firm has audit clients subject to ERISA audit requirements.

ERISA, Title I, Section 107, requires the auditor to maintain workpapers for at least six years.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Using audit sampling in a benefit plan audit is likely in which of the following audit areas?
   a. Benefit payments.
   b. Participant data and employee contributions.
   c. Contracts with insurance companies.
   d. Investments and related income.

37. A representative sample for audit sampling applications is required by SAS No. 39 (AU 350), as amended. As a result, the items must be selected in such a way that all items have an opportunity to be selected. Of the methods that meet this requirement, which one should be used when use of either of the other two methods is impractical?
   b. Systematic selection.
   c. Haphazard selection.

38. The PPC audit programs for individual audit areas include three sections to assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment. Which section is described as a combination of substantive analytical procedures and tests of details?
   a. Basic procedures.
   b. Extended procedures.
   c. Additional audit procedures.

39. Which of the following would not be considered a useful purpose of audit workpapers?
   a. Aids in planning the current engagement.
   b. Reinforces accountability.
   c. Provides information useful in modifying other audits.
   d. Aids in supervision.

40. The final assembly and completion of the audit file, referred to in SAS No. 103 as the documentation completion date, should occur within how many days of the report release date?
   a. 30 days.
   b. 60 days.
   c. 90 days.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. *(References are in parentheses.)*

36. Using audit sampling in a benefit plan audit is *likely* in which of the following audit areas? *(Page 121, Exhibit 3-2)*

   a. Benefit payments. [This answer is incorrect. The likelihood of using audit sampling in a benefit plan audit is *moderate* in the area of benefit payments. The likelihood is heavily dependent on the volume of benefit payments.]

   b. Participant data and employee contributions. [This answer is correct. The likelihood of using audit sampling in a benefit plan audit is *likely* in the area of participant data and employee contributions. The reason for this is that the volume of items tends to be relatively high.]

   c. Contracts with insurance companies. [This answer is incorrect. The likelihood of using audit sampling in a benefit plan audit is *rare* in the area of contracts with insurance companies. This is due to the fact that the auditor normally takes a primarily substantive approach and frequently can confirm aggregate amounts with another party.]

   d. Investments and related income. [This answer is incorrect. The likelihood of using audit sampling in a benefit plan audit is *rare to moderate* in the area of investments and related income. The reason for this is that the likelihood of sampling depends on the number of individual investment balances and the volume of individual investment transactions.]

37. A representative sample for audit sampling applications is required by SAS No. 39 (AU 350), as amended. As a result, the items must be selected in such a way that all items have an opportunity to be selected. Of the methods that meet this requirement, which one should be used when use of either of the other two methods is impractical? *(Page 123)*

   a. Random selection. [This answer is incorrect. Whenever practical, simple random selection using random numbers is one of two methods the auditor should use. Using this method does not make the audit sampling application a statistical sample.]

   b. Systematic selection. [This answer is incorrect. Systematic selection with a random start is the other of two methods the auditor should use when practical. Using this method does not make the audit sampling application a statistical sample.]

   c. Haphazard selection. [This answer is correct. The haphazard selection method may be used when the population is not numbered or when other circumstances make use of one of the other two methods impractical.]
39. Which of the following would not be considered a useful purpose of audit workpapers? (Page 126)

a. Aids in planning the current engagement. [This answer is incorrect. One useful purpose of audit workpapers is that they aid in the planning and performance of the current and future engagements since they indicate the level of risk in the audit.]

b. Reinforces accountability. [This answer is incorrect. Audit workpapers reinforce and demonstrate accountability of the company's policies and procedures.]

c. Provides information useful in modifying other audits. [This answer is correct. Audit workpapers are specific to the audit being conducted and have no usefulness or bearing on other audits.]

d. Aids in supervision. [This answer is incorrect. Audit workpapers aid in supervision and review since workpapers contain so much documentation.]

40. The final assembly and completion of the audit file, referred to in SAS No. 103 as the documentation completion date, should occur within how many days of the report release date? (Page 130)

a. 30 days. [This answer is incorrect. The final assembly and completion of the audit file can occur within a period of time greater than 30 days of the report release date, however, auditors may adopt shorter documentation completion periods.]

b. 60 days. [This answer is correct. The final assembly and completion of the audit file should occur within 60 days of the report release date per SAS No. 103. However, the auditor should be aware of any regulatory or state requirements that require a shorter documentation completion period.]

c. 90 days. [This answer is incorrect. The final assembly and completion of the audit file should occur within a period of time less than 90 days of the report release date as indicated by SAS No. 103.]
EXAMINATION FOR CPE CREDIT
Lesson 3 (EBPTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook.

30. Traditionally, auditors have used some common rules of thumb in quantifying planning materiality. These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. According to the text, for an employee benefit plan, what percent of total plan assets might be an appropriate rule of thumb?
   a. .5%.
   b. .5–1%.
   c. 1–1.5%.
   d. 1.5–2%.

31. If the auditor determines that there are financial statement elements on which the users’ attention tends to be focused for that particular entity, the auditor should estimate the planning materiality amount using which of the following as the benchmark?
   a. Total (or net) plan assets.
   b. Total (or net) additions to plan assets.
   c. Specific financial statement element attracting users’ attention.
   d. Do not select this answer choice.

32. Trey is currently performing tests of details on the audit of the employee benefit plan of Wilson Motorcycles. He is trying to determine the cutoff amount for individually significant dollar items that should not exceed tolerable misstatement. According to the text, what is a good rule of thumb for Trey to use for tolerable misstatement?
   a. One-quarter.
   b. One-third.
   c. One-half.
   d. Two-thirds.

33. Risks of material misstatement at the financial statement level often relate to which of the following?
   a. Specific relevant assertions at the class of transactions.
   b. Specific relevant assertions at the account balance.
   c. The plan’s control environment.
   d. Specific relevant assertions at the disclosure level.
34. Which of the following statements regarding prohibited transactions is accurate?
   a. The auditor is required to report all prohibited transactions.
   b. The auditor is required to report all material prohibited transactions, unless exempted from prohibited transaction rules he or she is aware of.
   c. The auditor is required to report all material and nonmaterial prohibited transactions, unless exempted from prohibited transaction rules he or she is aware of.
   d. Do not select this answer choice.

35. The auditor is required by professional standards to accomplish which of the following?
   a. Provide documentation of the audit strategy.
   b. Document significant revisions to the overall audit strategy resulting from changes in circumstances.
   c. Document both the audit strategy and significant revisions to it due to changes in circumstances.
   d. Do not select this answer choice.

36. As defined in SAS No. 39, when an auditor utilizes audit sampling, less than what percentage of the items within an account balance or class of transactions are the audit procedures applied to?
   a. 100 percent.
   b. 75 percent.
   c. 50 percent.
   d. 25 percent.

37. Stacy is designing a test of transactions in her audit of an employee benefit plan using stop-or-go sampling. Based on this approach, how many items should Stacy choose for her sample?
   a. Between 70 and 30.
   b. Between 60 and 30.
   c. Between 60 and 25.
   d. Between 50 and 25.

38. Usually, which of the following procedures approaches is appropriate for those assertions where there is a low risk of material misstatement in a significant audit area?
   a. Basic procedures.
   b. Extended procedures.
   c. Additional audit procedures.
   d. Do not select this answer choice.
39. Of the following statements, which one is accurate regarding support for the auditor’s report?

a. Generally, auditors should prepare audit documentation that provides a clear understanding of work performed.

b. Workpapers should always be used to support the audit report.

c. Oral explanations should not be used by the auditor to clarify or explain information in the audit documentation.

d. It is not necessary to document every matter the auditor considers during the audit.

40. SAS No. 56 (AU 329), *Analytical Procedures*, requires the auditor to document certain things when an analytical procedure is used as the principal substantive procedure for a significant financial statement assertion. Which of the following documentation might be included by the auditor, but is **not** required by SAS No. 56?

a. The expectation and the factors considered by the auditor in development of an analytical procedure, unless readily determinable from the work performed.

b. The results of the comparison between the expectation and recorded amounts.

c. Information about the auditor’s approach to evaluating the significance of the difference between the recorded amount and the expectation.

d. Additional procedures performed to address significant unexplained differences and the results of those procedures.
GLOSSARY

**AEBP**: The AICPAs document that addresses audits of employee benefit plans.

**Analytical Procedures**: Evaluations of financial information made by a study of plausible relationships among financial and nonfinancial data which involves comparing recorded amounts to expectations developed by the auditor.

**Benchmark**: Standard unit for the basis of comparison; universal unit that is identified with sufficient detail so that other similar classifications can be compared as being above, below, or comparable to the benchmark standard.

**Control Activities**: Include a variety of policies, procedures, practices or processes that are designed to ensure that necessary actions are taken to enforce the policies established by regulators or management.

**Control Environment**: The overall attitude, awareness and actions of directors and management (i.e. "those charged with governance") regarding the internal control system and its importance to the entity.

**DOL**: Department of Labor.

**ERISA**: Employee Retirement Income Security Act.

**Fraud**: The intentional deception resulting in injury to another. Fraud usually consists of a misrepresentation, concealment, or nondisclosure of a material fact, or at least misleading conduct, devices, or contrivance.

**HIPAA**: Health Insurance Portability and Accountability Act of 1996. The Privacy Rule standards address the use and disclosure of individuals' health information, called “protected health information” by organizations subject to the Privacy Rule, called “covered entities,” as well as standards for individuals' privacy rights to understand and control how their health information is used.

**Internal Control**: An accounting method, procedure, or system designed to promote efficiency, assure the implementation of policy, safeguard assets, and discover and avoid fraud or error.

**Limited-Scope Audit**: 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 who 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.

**Material Misstatement**: False or missing information, whether caused by fraud (including deliberate misstatement) or error. Material is very broadly defined as being large enough or important enough to cause stakeholders to alter their decisions.

**Nonattest Services**: Nonattest services include bookkeeping, tax compliance, assisting in the preparation of financial statements, assisting in hiring of client personnel, business valuation and development of corporate strategy planning. Attest services include audits, examinations, reviews, compilations, and agreed upon procedure services. If a service isn’t defined as an attest service, then it is a nonattest service.

**OCBOA**: Other Comprehensive Basis of Accounting.

**Outsourcing**: Subcontracting a process to a third-party company.

**Predecessor Auditor**: Independent CPA who either leaves the client willingly or is terminated and replaced by a Successor Auditor.

**Risk Assessment**: As a component of risk analysis, it involves identification, evaluation, and estimation of the levels of risks involved in a situation, their comparison against benchmarks or standards, and determination of an acceptable level of risk.
**SAS:** Statement on Auditing Standards.

**SQCS:** Statement on Quality Control Standards.

**Statistical Sampling:** Selecting from a population on a systematic or random basis, which (upon mathematical manipulation) yield generalizations about the population.

**Substantive Testing:** Activities performed by the auditor during the substantive testing stage of the audit that gather evidence as to the completeness, validity, and/or accuracy of account balances and underlying classes of transactions.

**Tests of Details:** A collection of certain evidence-gathering activities auditors perform during the substantive stage of the audit that have as their objective the gathering of substantive evidence.

**Tolerable Misstatement:** The degree of acceptable misstatement in substantive testing without materially misstating the financial statements.

**Transaction Testing:** Evidence gathering activities directed at classes of transactions underlying a particular account balance assertion. It is primarily applicable where the audit approach for a particular account balance assertion is in-depth.
# INDEX

## ADMINISTRATION OF EMPLOYEE BENEFIT PLANS
- Plan administrators ........................................... 84

## ADMINISTRATION OF THE AUDIT
- Accepting a new or continuing client ......................... 11
- Establishing terms of the engagement ......................... 25

## AUDITOR'S REPORTS
- Reference to work of other auditors ......................... 113

## AUDIT PLANNING
- Accepting a new or continuing client ......................... 11
- Audit programs
  - Organization and structure ................................ 124
- Documentation of planning activities
  - Internal control documentation .............................. 81
  - Establishing terms of the engagement ..................... 25
- Health Insurance Portability and Accountability Act .... 57
- Initial engagement ........................................... 24
- Inquiry of plan management ................................ 55
- Internal control, understanding of ............................ 68
- Review of financial statements and Form 5500 .......... 57
- Review of laws and regulations ................................ 55
- Review of plan documents ................................... 56
- Pending amendments ......................................... 57
- Plan defects .................................................. 57
- Service organizations ........................................ 82, 114
- Short audit periods .......................................... 24
- Timing and coordination considerations
  - Audit of plan sponsor ....................................... 114
  - Financial statements of trustees or insurance companies .............................................. 115
  - Multiemployer plans ........................................ 115
  - Reading Form 5500 .......................................... 115
  - Service organization report ................................ 114
- Use of a specialist, planning considerations ................. 111
- Workpapers, organization and structure ..................... 124

## AUDIT RISK
- Parties in interest and prohibited transactions ............ 109
- Significant risks in an employee benefit plan audit .... 107

## AUDIT SAMPLING
- Determining audit sampling applications .................... 120
  - Example of a nonsampling application ..................... 120
  - Likelihood of using audit sampling by audit area .......... 121
- Methods
  - Substantive testing ......................................... 122
  - Transaction testing .......................................... 122
- Tests of transactions using sampling ......................... 122
  - Evaluation .................................................. 123
  - Planning the test .......................................... 123
  - Sample selection ........................................... 123

## AUDIT STRATEGY
- Timing of the audit strategy ................................ 111
- Auditing literature ........................................... 10

## CHANGES IN AUDIT REQUIREMENTS
- Planning decisions and judgments ............................ 99

## COMMUNICATIONS WITH CLIENT
- Engagement letter ............................................ 25

## CONFIRMATION LETTERS
- Engagement letter ............................................ 25

## DEPARTMENT OF LABOR (DOL)
- Independence rules ........................................... 16
- Limited-scope audit .......................................... 18, 20

## DOCUMENTATION
- Internal control ................................................ 72
- Planning decisions and judgments ........................... 103, 110
- Preparing the detailed audit plan ........................... 54
- Understanding the entity and its environment ............. 54

## ELECTRONIC DATA PROCESSING
- Service auditors' reports ................................... 83
- Service organizations ......................................... 82

## ENGAGEMENT ACCEPTANCE CONSIDERATIONS
- Ability to accept engagement ................................ 12
  - Ability to meet ERISA audit requirements ................. 17
  - Ability to meet time requirements and deadlines ...... 17
  - Independence—ERISA and DOL rules ...................... 16
  - Documenting the engagement acceptance or retention decision ........................................... 25
- Documenting the terms of the engagement ................. 26
- Establishing the terms of the engagement .................. 25
- Management integrity ........................................ 18
- Scope of the audit ............................................ 19
  - DOL limited-scope audit .................................... 20
  - Initial audit .................................................. 24
  - Nature of the plan .......................................... 21
  - Need for SEC filing ......................................... 24
  - Need to test participant data .............................. 23
  - Preparation of the Form 5500 .............................. 24
  - Third-party service organizations ......................... 22
  - Type of financial statements—beginning of year benefit information date ............................... 23
  - Type of financial statements—OCBOA statements ...... 23
  - Type of financial statements—trust fund ................. 23
  - Type of insurance contracts ................................ 23
  - Type of investments ........................................ 22
  - Type of report on required supplemental schedules ..... 23
  - Type of trust arrangement ................................ 22

## ERISA
- Audit requirements
  - Audit workpaper considerations ........................... 132

## ESOP
- Independence .................................................. 17

## FRAUD
- Fraud risk assessment
  - Inquiries of management and others ....................... 37
  - Fraud risk assessment process ............................. 73

## HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT (HIPAA)
- Audit documentation .......................................... 58
- Audit planning issues ........................................ 58
- Business associates .......................................... 57
- Confidentiality agreements .................................. 57
- Privacy rule .................................................... 57
COMPANION TO PPC’S GUIDE TO AUDITS OF EMPLOYEE BENEFIT PLANS

COURSE 2

SPECIAL AUDITING CONSIDERATIONS (EBPTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course addresses special auditing considerations including contributions received and receivable, investments, contracts with insurance companies, participant data, benefit payments, benefit obligations, other assets, liabilities, and operating expenses.

PUBLICATION/REVISION DATE: February 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Employee Benefit Plans

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of Generally Accepted Auditing Standards (GAAS)

CPE CREDIT: 6 QAS Hours, 6 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by February 28, 2011

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Employer Contributions Received and Receivable, Audit of Investments, Contracts with Insurance Companies, and Participant Data

Completion of this lesson will enable you to:
• Describe audit procedures for contributions and contribution receivables and explain the information included in the schedules of Form 5500.
• Identify the factors that influence audit procedures for investments.
• Describe auditing of contracts with insurance companies.
• Identify the importance of auditing participant data and the basic audit procedures.

Lesson 2—Benefit Payments, Benefit Obligations, Other Assets, Liabilities, and Operating Expenses, and Change in Service Organizations

Completion of this lesson will enable you to:
• Identify audit procedures for testing benefit payments.
• Describe how benefit obligations are calculated and tested.
• Summarize audit procedures for other assets, liabilities, and operating expenses.
• Recognize appropriate analytical procedures and identify required procedures for a change in service organizations.
TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
EBPTG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: Employer Contributions Received and Receivable, Audit of Investments, Contracts with Insurance Companies, and Participant Data

INTRODUCTION

This lesson discusses specific audit considerations and procedures related to the unique or significant account balances and transaction classes of employee benefit plans, namely:

- Contributions.
- Investments.
- Contracts with insurance companies.
- Participant data.
- Benefit payments.
- Benefit obligations.
- Other assets, liabilities, and operating expenses.
- Other audit considerations.

Some procedures discussed in this lesson are not necessary in a DOL limited-scope audit. They relate primarily to investments held by a bank or similar institution, or insurance company, that prepares and certifies to the information on the investments as both complete and accurate.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe audit procedures for contributions and contribution receivables and explain the information included in the schedules of Form 5500.
- Identify the factors that influence audit procedures for investments.
- Describe auditing of contracts with insurance companies.
- Identify the importance of auditing participant data and the basic audit procedures.

Authoritative Literature

The following authoritative literature gives audit guidance that is specifically or particularly relevant to employee benefit plan audits:

- SAS No. 73 (AU 336), *Using the Work of a Specialist*, applies when an auditor uses the work of a specialist in obtaining evidential matter about aspects of the financial statements. The SAS specifically identifies using the work of actuaries related to actuarial determinations and the work of appraisers related to valuing restricted securities. Both of these uses of specialists are common in auditing employee benefit plan investments and benefit obligations.

- SAS No. 70 (AU 324), *Service Organizations*, as amended, specifically applies when an employee benefit plan uses the services of another organization, such as a bank trust department, to invest and service plan assets. The SAS gives guidance on factors the auditor should consider in auditing investments and insurance contracts in trustee arrangements when a service organization executes and processes
transactions for the plan. It also gives detailed guidance on the plan auditor’s considerations in deciding the need for, or desirability of, obtaining a service auditor’s SAS 70 report on the controls at the service organization and on the auditor’s use of the service auditor’s SAS 70 report.

- AICPA Audit and Accounting Guide, Employee Benefit Plans (AEBP), discusses aspects of auditing unique to employee benefit plans. It applies to audits of all types of benefit plans.

**CONTRIBUTIONS RECEIVED AND RECEIVABLE**

Plans receive contributions from the plan sponsor (employer) and contributory plans also receive voluntary or mandatory contributions from plan participants (employees). Contributions may be in the form of cash or in noncash forms such as real estate or stock. Noncash contributions must be recorded at fair value.

**Implications of ERISA Requirements for the Audit of Contributions**

The ERISA has a requirement for minimum annual funding of defined benefit retirement plans. Certain defined contribution plans (money purchase plans and target benefit plans) are also subject to ERISA minimum funding requirements and must make the contribution required by the plan’s contribution formula.

ERISA may also require sponsors of single-employer defined benefit retirement plans to fund the annual contribution in quarterly installments. If quarterly installments are required, each installment must be at least 25% of the required annual payment, as defined. Timing of payment of contributions to qualified defined contribution retirement plans is influenced by the fact that the sponsor’s payment applicable to a particular year is deductible on that year’s tax return if it is paid by the return’s due date (including extensions).

ERISA limits the employer contribution to a defined benefit retirement plan to the amount necessary to fund the ERISA-specified maximum annual benefit that the plan may provide an individual participant. There is also a limit on the maximum annual contribution to a defined contribution retirement plan’s individual participant accounts from all sources, that is, employer and employee contributions and allocated forfeitures.

These rules mean that there is a minimum and maximum employer contribution and receivable that the auditor may expect to be reflected in the plan’s financial statements.

**Auditing Procedures for Contributions**

**Analytical Procedures.** Analytical procedures can be very effective in auditing contributions to all types of employee benefit plans. Such procedures may include comparison of the current year and prior year contribution and comparison of the current and prior year ratios of contribution to number of plan participants.

Other analytical procedures can be developed by referring to plan provisions related to the employer contribution. The rates and bases specified in the plan and the sponsor’s board resolution can be applied to data from the employer’s records. For example, for a profit-sharing plan that provides for an employer contribution equal to a specified percentage of the employer’s net income, an overall test can be performed by applying the contribution rate to the relevant income amount. The auditor would test the income amount by referring to audited financial statements of the plan sponsor. Also, if the auditor of such a profit-sharing plan does not audit the plan sponsor’s financial statements, he or she may need to arrange for the sponsor’s auditor to apply necessary procedures to test or calculate the employer contribution. (If the sponsor’s financial statements are not audited or a report of the other auditor’s test or calculation of the contribution cannot be obtained, the plan auditor may need to modify his or her report because of the scope limitation.)

**Vouching and Confirmation.** The contribution may be traced to the employer’s board of director’s minutes authorizing the contribution and to the plan’s cash receipts, deposits as evidenced on bank statements or trustee reports, or accounts receivable. The auditor may also be able to trace the contribution to the employer’s tax return. The auditor may also decide to confirm the contribution (and any related receivable) with the employer. Some sponsors of health and welfare benefit plans transmit the contribution directly to a third-party administrator; in such a case, the auditor may confirm the contribution with the third-party administrator. If the auditor has audited the employer’s financial statements, he may be able to trace the contribution to those audit workpapers.
**Noncash Contributions.** The fair value at the date of contribution should be reviewed for any noncash contributions. Procedures would be similar to those for auditing the fair value of plan investments.

**Rollover Contributions.** Rollover contributions are transfers to the plan from another qualified plan (or from an individual retirement account if the contributions originated in a qualified plan and were then transferred to an individual retirement account). Many plans allow rollover contributions from employees. Some plans allow employees to roll over contributions before they are eligible to participate in the plan. If the plan allows for rollovers, the auditor should consider performing one or more of the following procedures:

- Determine that the rollover was made according to plan provisions.
- Determine that the rollover is properly reflected in the participant’s account.
- Test the transfer of the assets from the prior trustee/custodian to the current trustee/custodian. If the plan provides for participant-directed investments, determine that the individual investments were transferred according to the participant’s instructions.

**Defined Benefit Plan Contribution.** For a defined benefit retirement plan, the auditor should compare the employer contribution to information in the actuary’s report and determine that the contribution meets ERISA’s minimum funding requirements. If the actuary has already prepared the Schedule MB or Schedule SB to Form 5500, the auditor can review it for information about the minimum required funding. The auditor should also assess whether contributions are properly reflected in the appropriate fiscal period in compliance with GAAP. Some or all of these procedures may also be appropriate for a defined benefit health and welfare plan that uses an actuary to determine the employer contribution amount.

The current economic conditions may cause some sponsors of defined benefit plans to apply for a funding waiver because of their current financial difficulties. In these situations, AICPA representatives have stated that plans should record a contribution receivable for the minimum required contribution and an appropriate allowance for doubtful accounts for the uncollectible portion. This treatment appears consistent with the guidance in FASB ASC 960-310-25-2 because it states that receivables include amounts due under “legal or contractual requirements.”

**Form 5500**

**Content of Form 5500.** The Form 5500 (2006) contains general questions such as the name of the plan, plan sponsor, plan administrator, and form preparer; the type of plan; the number of participants at the end of the plan year; and a code for the types of benefits provided under the plan. The instructions to Form 5500 include a table of the available plan characteristics codes.

Line 10 of the Form 5500 asks the preparer to check which schedules are applicable to the plan and, for some schedules, asks for the number of schedules attached.

**Form 5500-EZ**

Form 5500-EZ (2006), [Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan] is filed by certain one-participant plans. Form 5500-EZ does not include any plan financial statements and has no audit requirement; only contributions, distributions, transfers, other income, plan expenses, total plan assets and liabilities, and the current value of certain specific assets must be disclosed. Schedules B and E must be attached to Form 5500-EZ, if applicable.

**Schedule A—Insurance Information**

Schedule A (2006), “Insurance Information,” must be attached to Form 5500 if any benefits of a defined benefit, defined contribution, or welfare benefit plan are provided by an insurance company or similar organization.

Part I of Schedule A asks for summary information about all insurance contracts included in the Schedule. Part II relates to insured pension plans (defined benefit or defined contribution). It asks for information about premiums paid on insurance contracts and for activity (dividends and interest, benefits paid or annuities purchased, adminis-
trative charges, etc.) in unallocated contracts, for example DAs and IPGs, that are not maintained in separate accounts. It also asks for the current value of interests in general and separate accounts.

**Schedule B—Actuarial Information**

Schedule B (2006), “Actuarial Information,” must be attached to Form 5500 or Form 5500-EZ if the plan is a defined benefit retirement plan subject to ERISA’s minimum funding requirement. Rev. Rul. 89-87 states that an employer that terminates a defined benefit pension plan must attach a Schedule B for the year in which the plan is terminated but not for subsequent years.

The schedule discloses the liability for benefits of retirees, terminated participants with vested benefits, and active participants at the beginning of the year; employer and employee contributions during the year; activity in the funding standard account (normal cost for the current year, amortization of gains and losses, etc.), any resulting deficiency in that account, and any required additional funding.

The actuarial cost method and actuarial assumptions used in determining the normal cost and required contribution are also disclosed in Schedule B.

Schedule B must be signed by an enrolled actuary.

**Schedule C—Service Provider Information**

Schedule C (2006), “Service Provider Information,” is filed with Form 5500 by large pension and welfare plans. It lists persons who received $5,000 or more to provide services to the plan; for example, accountants, actuaries, brokers, custodians, investment advisors, lawyers, etc.

Part II of Schedule C explains the reason for terminating an accountant or actuary. Any material disputes or disagreements concerning the termination must be explained, even if they were resolved before the termination. The terminated party must receive a copy of the schedule and a completed copy of the notice included in the instructions. The terminated party then has the right to submit comments about the termination.

**Schedule D—DFE/Participating Plan Information**

Schedule D (2006), “DFE/Participating Plan Information,” must be filed with Form 5500 if any defined benefit, defined contribution, or welfare benefit plan participated in or invested in one or more common/collective trusts, pooled separate accounts, master trusts, or 103-12 investment entities at any time during the plan year. (This schedule must also be completed by any trusts, accounts, or other investment arrangements that file Form 5500 as a “direct filing entity” or DFE.)

Part I of Schedule D asks for the name and sponsor of the investment account, trust, etc. The Schedule also asks for the value of the interest at the end of the plan year. Part II of Schedule D should only be completed by DFEs.

**Schedule E—ESOP Annual Information**

Schedule E (2006), “ESOP Annual Information,” must be filed with Form 5500 or Form 5500-EZ if a pension benefit plan contains an ESOP. All such plans must file the form.

**Schedule G—Financial Transaction Schedules**

Schedule G (2006), “Financial Transaction Schedules,” must be filed with Form 5500 by any large plan with loans or fixed income obligations in default or determined to be uncollectible as of the plan year end, leases in default or classified as uncollectible, or nonexempt (prohibited) transactions. The auditor must also report on this schedule if any of the previously mentioned items exist.

The auditor should test the data provided to the actuary upon which the actuarial calculation of the required contribution is based as part of the test of participant data.
Schedule H, “Financial Information,” must be filed with Form 5500 by “large” pension plans or “large” welfare benefit plans, except for the following plans:

- Fully insured, unfunded, or unfunded/insured welfare benefit plans.
- Fully insured pension plans (pension plans that provide benefits exclusively through fully guaranteed, that is, allocated, insurance contracts that meet the conditions of DOL Reg. 2520.1044-44).
- Plans that filed a Form 5500 as a “small” plan in the prior year and qualify under the “80-120 participant” rule as a “small” plan.

The instructions to Schedule H state that the cash, modified cash, or accrual basis of accounting may be used. However, assets and liabilities must be at current value, which the instructions define as fair market value when available, otherwise, fair value as determined in good faith by a trustee or fiduciary, “assuming an orderly liquidation at [the] time of the determination.”

**Defined Contribution Plan Contribution.** Some defined contribution plan documents provide for using nonvested participant accounts that are forfeited when the participant terminates service (referred to as forfeitures) to reduce the employer contribution. If such a provision exists, the auditor should determine that the employer contribution was appropriately reduced by the amount of the forfeitures.

**Multiemployer Plan Contribution.** Employer contributions to multiemployer plans are usually self-assessed by the participating employers based on uniform contribution rates and the number of hours or days worked or the number of employees. The contributions are usually remitted to the plan administrator with preprinted contribution reports containing information that supports the contribution amount.

To audit contributions to a multiemployer plan, the auditor should obtain a schedule of all participating employers and consider its completeness by referring to plan documents or collective bargaining agreements. The auditor should test amounts on the individual employer contribution reports by tracing the basis for the contribution to provisions in the plan document or collective bargaining agreement and by tying in to the total contribution for all employers. The total contribution for all employers should be related to the actuary’s report and tied into the plan’s cash receipts and accounts receivable.

The base upon which the individual employer’s contribution is determined, for example, payroll, should be traced to the employer’s supporting documents and tested, if necessary. The auditor may be able to arrange for the employer’s auditor to apply the necessary procedures.

The auditor may decide to confirm the contribution (and any related receivable) with the individual employers.

**Contribution Receivable from Employer**

The criteria for an employee benefit plan to record a contribution receivable for amounts due from the employer is that the receivable represent a formal commitment and legal or contractual requirement for the employer to make a contribution.

Evidence of a formal commitment that the auditor may consider includes the following:

- A resolution by the employer’s governing body approving a specified contribution.
- A consistent pattern of making payments after the plan’s year end under an established funding policy that attributes such payments to the preceding plan year.
- The employer’s deduction of a contribution on its federal income tax return for periods ending on or before the reporting date.
- The employer’s recording of a contribution payable to the plan as of the reporting date. However, the existence of an accrual is not in itself sufficient support for recognizing a receivable.
The auditor should obtain support for these evidences of a formal commitment by applying procedures to the employer’s records, referring to the audit workpapers if he has audited the plan sponsor, or arranging for the plan sponsor’s auditor to apply the procedures. For example, the auditor could examine the appropriate minutes of the employer’s board of directors or make copies of, or a cross-reference to, minutes contained in the workpapers for the audit of the employer’s financial statements. Or, the auditor might examine support for the employer’s payment of the contribution after the plan’s year end or arrange for the employer’s auditor to vouch such a payment during the audit of the employer’s financial statements.

The auditor should consider confirming the receivable with the employer. SAS No. 67 (AU 330.34), The Confirmation Process, states the presumption that the auditor will confirm “accounts receivable” unless the use of confirmations would be ineffective, accounts receivable are immaterial, or the combined assessment of inherent risk and control risk is low, and that assessment, along with evidence provided by analytical procedures and other substantive procedures, reduces audit risk related to receivables to an acceptably low level. However, AU 330.34a defines accounts receivable as “the entity’s claims against customers that have arisen from the sale of goods or services in the normal course of business.” It is believed that contributions receivable by an employee benefit plan do not fall within this definition. Nevertheless, AEBP, Paragraph 8.03f, includes confirmation of contributions received and receivable as an example of a substantive audit procedure for employer and employee contributions.

Some factors to consider in deciding whether to confirm contributions received or receivable include the following:

- The effectiveness of internal controls related to contributions and cash receipts.
- Whether any risks relating to employer contributions were identified during the risk assessment.
- Whether the contribution is paid directly into a plan bank account or whether it is paid to a trustee or third-party plan administrator or a central bank account that receives deposits related to several unrelated plans.
- Whether the plan is a multiemployer plan or a single-employer plan.
- Whether the plan auditor audits the plan sponsor’s financial statements and can trace contributions to those audit workpapers or can arrange for another auditor of the plan sponsor to do so.
- Whether the plan auditor can trace the contribution to the plan sponsor’s records.
- The materiality of the unpaid receivable balance after subsequent receipts are examined.
- Whether other items will also be confirmed, such as disbursements made by a third-party administrator to pay claims, expenses, and insurance premiums.

The auditor should examine support for any subsequent receipts of the contribution receivable. This procedure can provide evidence about the existence of the receivable and also indicate whether there is a need to consider an allowance for uncollectible receivables.

**Allowance for Uncollectible Receivable.** An allowance for estimated uncollectible contributions receivable should be provided in the plan’s financial statements. Thus, the auditor should consider whether there is a need for an allowance and the adequacy of any allowance.

In considering the need for an allowance for uncollectible contributions receivable, the auditor should first determine whether the receivable was collected in the subsequent period. If quarterly installments are required for single-sponsor defined benefit plans, each installment is due two weeks after each quarter ends. Contributions to a defined contribution plan may be made as late as the due date of the sponsor’s tax return. Thus, the contribution receivable may not have been fully collected at the time of the plan audit. If it has not, the auditor should determine whether any required quarterly installments were received on time, and should also consider the employer’s economic condition for any indication of possible collectibility problems. This consideration should be made for the sponsor of a single-employer plan and for all the employers in a multiemployer plan from which a receivable is due.
Also, an employer that partially or completely withdraws from a multiemployer plan must continue to fund a proportional share of the plan’s unfunded vested benefits. This withdrawal liability is payable over 20 years. The auditor should ask whether any such receivable is due to the plan and has been reported as a receivable and should consider its collectibility.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following Statements on Auditing Standards (SAS) provides audit guidance that is specifically relevant to audits of employee benefit plans?
   a. SAS No. 70.
   b. SAS No. 72.
   c. SAS No. 92.
   d. SAS No. 107.

2. Shelly is auditing the employee benefit plan of Greenhouse Financials. She has decided to employ the use of analytical procedures as part of her auditing procedures. Which of the following is an example of an analytical procedure that Shelly could utilize?
   a. Shelly could send out a letter to a third-party administrator to verify that a contribution was funded into the plan.
   b. Shelly can compare last year’s contributions to this year’s contributions based on the number of participants in the plan.
   c. Shelly could verify that contributions were approved by referring to the board of director’s minutes and bank statement deposits.

3. Some employee benefit plans allow employees to roll over contributions prior to being eligible to participate in the plan. If the plan allows for rollovers, the auditor should consider performing any of the following procedures except:
   a. Determine that the rollover was made in accordance with plan provisions.
   b. Determine that the rollover has no provision that would prevent future rollover to another plan.
   c. Determine that the rollover is properly posted to the participant’s account.
   d. Test the transfer of assets from the prior trustee or custodian to the current trustee or custodian.

4. Steven has received the assumptions that the actuary utilized when determining the normal cost and required contributions for the employee benefit plan that he is currently auditing. Steven is required to submit this information with the company’s Form 5500. Where should Steven place the actuary’s report?
   a. Schedule A.
   b. Schedule B.
   c. Schedule D.
   d. Schedule E.

5. When deciding whether to confirm contributions and contributions receivable, one factor to consider is the effectiveness of internal controls related to:
   a. Stocks and bonds.
   b. Cash receipts.
   c. Promissory notes.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. (References are in parentheses.)

1. Which of the following Statements on Auditing Standards (SAS) provides audit guidance that is specifically relevant to audits of employee benefit plans? (Page 147)

   a. SAS No. 70. [This answer is correct. SAS No. 70, Service Organizations, as amended, provides audit guidance that is specifically relevant to audits of employee benefit plans and specifically applies when an employee benefit plan uses the services of another organization to invest and service plan assets.]

   b. SAS No. 72. [This answer is incorrect. SAS No. 72 provides guidance regarding letters for underwriters and certain other requesting parties.]

   c. SAS No. 92. [This answer is incorrect. SAS No. 92 provides guidance on auditing derivative instruments, hedging activities, and investments in securities.]

   d. SAS No. 107. [This answer is incorrect. SAS No. 107 addresses audit risk and materiality in conducting an audit.]

2. Shelly is auditing the employee benefit plan of Greenhouse Financials. She has decided to employ the use of analytical procedures as part of her auditing procedures. Which of the following is an example of an analytical procedure that Shelly could utilize? (Page 148)

   a. Shelly could send out a letter to a third-party administrator to verify that a contribution was funded into the plan. [This answer is incorrect. When Shelly sends out letters to other parties to verify information, she is applying the audit procedure of vouching. Vouching is an audit procedure used in employee benefit plan engagements, but is not an analytical procedure.]

   b. Shelly can compare last year’s contributions to this year’s contributions based on the number of participants in the plan. [This answer is correct. Analytical procedures are the evaluation of financial information made by a study of plausible relationships among both financial and nonfinancial data. They can be very effective in auditing contributions to all types of employee benefit plans.]

   c. Shelly could verify that contributions were approved by referring to the board of director’s minutes and bank statement deposits. [This answer is incorrect. This is an example of confirmation. Confirmation is when the auditor validates information themselves by researching documents to make sure a transaction took place and was recorded accurately.]

3. Some employee benefit plans allow employees to roll over contributions prior to being eligible to participate in the plan. If the plan allows for rollovers, the auditor should consider performing any of the following procedures except: (Page 149)

   a. Determine that the rollover was made in accordance with plan provisions. [This answer is incorrect. One procedure the auditor should consider performing is to determine that plan provisions were followed when the rollover was made to verify that it is a valid rollover.]

   b. Determine that the rollover has no provision that would prevent future rollover to another plan. [This answer is correct. The auditor does not need to determine at the time of the rollover whether the rollover can be rolled over to yet another plan in the future since that does not effect the current rollover.]

   c. Determine that the rollover is properly posted to the participant’s account. [This answer is incorrect. The auditor should ensure that the participant’s account properly reflects the rollover and it was properly deposited in the correct account.]
d. Test the transfer of assets from the prior trustee or custodian to the current trustee or custodian. [This answer is incorrect. The auditor should determine that investments were transferred in accordance with instructions provided by the participant.]

4. Steven has received the assumptions that the actuary utilized when determining the normal cost and required contributions for the employee benefit plan that he is currently auditing. Steven is required to submit this information with the company’s Form 5500. Where should Steven place the actuary’s report? (Page 149)

   a. Schedule A. [This answer is incorrect. Schedule A, Insurance Information, must be attached to Form 5500 if any benefits of a defined contribution, defined benefit, or welfare benefit plan are provided by an insurance company or similar organization.]

   b. Schedule B. [This answer is correct. If the plan is a defined benefit retirement plan subject to ERISA’s minimum funding requirement, Schedule B, Actuarial Information, must be attached to Form 5500 or Form 5500-EZ.]

   c. Schedule D. [This answer is incorrect. Schedule D, DFE/Participating Plan Information, must be filed with Form 5500 if, at any time during the plan year, any defined benefit, defined contribution, or welfare benefit plan participated in or invested in one or more common/collective trusts, pooled separate accounts, master trusts, or 103-12 investment entities.]

   d. Schedule E. [This answer is incorrect. If a pension benefit plan contains an ESOP, Schedule E, ESOP Annual Information, must be filed with Form 5500 or Form 5500-EZ.]

5. When deciding whether to confirm contributions and contributions receivable, one factor to consider is the effectiveness of internal controls related to: (Page 152)

   a. Stocks and bonds. [This answer is incorrect. The effectiveness of internal controls relating to stocks and bonds is not a factor that should be considered when determining whether to confirm contributions and contributions receivable, since stocks and bonds are usually held by a third party.]

   b. Cash receipts. [This answer is correct. One factor to consider when deciding whether to confirm contributions and contributions receivable is the effectiveness of internal controls related to contributions and cash receipts. If the internal controls are not strong, then the confirmation of cash receipts could be misleading.]

   c. Promissory notes. [This answer is incorrect. Promissory notes are not recognized as contributions or contributions receivable so the effectiveness of the internal control structure to promissory notes is not relevant.]
INVESTMENTS

Factors That Influence the Audit of Investments

The major accounting requirements for investments of employee benefit plans are to present investments at fair value and to use the trade date and ex-dividend date to record securities transactions and income.

In addition to the risk assessment, the nature and extent of auditing procedures for investments depends on factors such as the following:

- The physical location of the investments and related records.
- Whether the investments are administered by the plan (and merely held by a custodian) or are administered by a trustee, and if there is a third-party trustee, whether the trust arrangement is discretionary or nondiscretionary.
- Whether the audit is a full-scope audit or a DOL limited-scope audit.

These factors are explained in the following paragraphs. The section then discusses basic auditing procedures for investments, followed by discussions of specific audit considerations for the following types of investments:

- Investments held in discretionary trusts.
- Investments in common/collective trusts.
- Investments in master trusts.
- Other types of investments, such as real estate, mortgages, limited partnership interests, loans (including participant loans), and derivatives.

Physical Location of Investments and Records. The audit procedures for plan investments are influenced by their location. An employee benefit plan’s investment securities may be held in the plan’s safe deposit box at a bank or in a vault at the plan or sponsor’s location. These situations are rare, but if either is the case, the auditor’s procedures likely will include examining the securities. Records relating to the plan’s investments are likely to be located off premises if the plan has a third-party plan administrator.

Type of Investment Administration and Trust Arrangement. A significant influence on the audit approach for investments is whether the investments are administered by the plan (and merely held by a custodian) or are administered by a trustee, and if there is a third-party trustee, whether the trust arrangement is discretionary or nondiscretionary.

With nontrusteed investments or nondiscretionary trust arrangements, the auditor can usually obtain adequate audit evidence about investments by applying procedures to the plan’s investment records. The reason is that in a nondiscretionary (also called “directed”) trust arrangement, the trustee merely executes investment transactions at the plan’s specific direction and holds the investments. The trustee provides the plan with a report of investment activity, but the plan usually maintains the documents supporting the transactions, such as investment transaction authorizations, brokers advices, etc., that the auditor can examine.

With discretionary trust arrangements, the trustee has discretion to initiate investment transactions within the broad authority granted him or her under the trust agreement without specific authorization of individual transactions. The plan receives a trustee report of investment activity but usually does not have independent records of the transactions or supporting documents. Thus, the auditor may need to obtain a service auditor’s SAS 70 report or apply procedures at the trustee’s location.

Limited-scope Audit. In a DOL limited-scope audit, no procedures are applied to information on plan investments (and related transactions) held by a bank or similar institution (for example, a regulated savings and loan associa-
tion or credit union) that is prepared and certified to as both complete and accurate by the financial institution. AEBP, Paragraph 7.66, notes that in a DOL limited-scope audit, the auditor’s responsibilities for the investments covered by the limited-scope exception include the following:

a. Reading the certification.

b. Considering whether the certifying entity is a qualifying institution under DOL regulations.

c. Comparing the certified investment information to the financial information in the plan’s financial statements and disclosures.

d. Performing procedures to determine that contributions received and benefit payments made, as reported by the trustee or custodian, comply with the provisions of the plan.

e. Assessing the form and content of the financial statement disclosures related to the certified investment information for conformity with GAAP and compliance with DOL rules and regulations.

If, while performing the procedures discussed in the preceding paragraph, the auditor becomes aware that the information provided in the certification report is incomplete, incorrect, or somehow unsatisfactory, the auditor should perform additional procedures. For example, if the trustee’s certified fair market value of a nonactively-traded investment has remained the same for three years, the auditor should consider having the plan administrator ask the trustee how the investment was valued and, if appropriate, obtain a copy of a valuation report, if any. If necessary, the trustee should correct and recertify the report or the auditor should record any necessary adjustments. The auditor should also determine that the investment information supplied by the trustee is on the same basis of accounting as the financial statements. If not, appropriate adjustments should be made to the information.

If the plan holds other investments that are not certified by the trustee, they should be subjected to appropriate audit procedures because they are not covered by the limited scope exemption. Likewise, if the certification covers only a portion of the year under audit, the auditor should apply full-scope audit procedures to the portion of the year not covered by the certification if such information is not covered by the certification of another qualified trustee or custodian unless that period is considered immaterial. This situation may occur when a plan has changed trustees or custodians during the plan year.

Basic Auditing Procedures for Investments

The basic audit assertions and procedures for employee benefit plan investments are similar to those in any audit, although the manner of obtaining the evidence may differ for investments held in discretionary trusts versus nontrusteed investments or investments in nondiscretionary trusts. Also, in an ERISA audit, basic audit procedures should include procedures directed to compliance with ERISA requirements related to investments. The following paragraphs summarize those assertions and procedures.

SAS No. 92 (AU 332), Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, provides guidance on auditing investments in debt and equity securities, investments accounted for under FASB ASC 323 (formerly APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock), and derivative instruments or hedges. In addition, SAS No. 101 (AU 328), Auditing Fair Value Measurements and Disclosures, provides guidance on auditing fair value measurements and disclosures in financial statements. The following discussion of auditing procedures for employee benefit plan investments is based on the guidance in AEBP and SAS Nos. 92 and 101.

Auditing Investment Existence. The auditor should test existence of the plan’s investments as of the financial statement date by examining evidence of ownership on hand at the plan such as stock certificates, deeds (for real estate owned), etc., or by confirmation with the custodian. (As previously mentioned, it is uncommon for the plan to have physical custody of the investments; even when the plan administers its investments, a custodian typically holds them in safekeeping.) The auditor should also consider obtaining confirmation of the same information from the party named as having discretion to make investment decisions such as the plan administrator, investment committee, or investment advisor.

AEBP, Paragraph 7.16c, states that if the plan’s investments are held by a bank’s trust department, a confirmation from the bank ordinarily is acceptable evidence of existence and ownership. The paragraph also states that the
The auditor may obtain information about the trustee’s responsibility and financial capability. The paragraph indicates the auditor may consider the following procedures:

- Review the trust instrument to determine the trustee’s responsibilities.
- Determine whether the trustee has insurance covering the plan assets under its control.
- Read recent financial statements of the trustee.

Other procedures include reviewing credit bureau ratings, if available, and reviewing financial or trade publications for relevant information about the trustee or custodian.

When confirming investments held by a third party (such as a trustee or a hedge fund), the auditor should carefully evaluate the adequacy of the confirmation. Occasionally, a third party may confirm the total amount of investments in the aggregate rather than on an individual investment basis. For instance, a confirmation from a trustee may indicate the plan has “total investments of $145,000” or “$110,000 of total investments in private equity securities, $25,000 of total investments in interests in limited partnerships, and $10,000 of total investments in debt securities.”

According to AICPA Auditing Interpretation No. 1 of SAS No. 101 (AU 9328.01.04), Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value, and AICPA Auditing Interpretation No. 1 of SAS No. 92 (AU 9332.01.04), Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist, a confirmation from a third party that confirms investment balances in the aggregate is not sufficient audit evidence regarding existence. However, a confirmation that is disaggregated, in other words, one that includes details on an investment-by-investment basis typically provides sufficient evidence regarding the existence assertion. The following is an example of a disaggregated confirmation:

100 shares of common stock of private company A with a fair value of $60,000; 75 shares of preferred stock of private company B with a fair value of $50,000; 45 units of limited partnership interest XYZ with a fair value of $25,000; real estate property ABC with a fair value of $75,000.

The confirmation to the custodian or trustee should include an inquiry about the status of any securities in transit on the financial statement date.

**Auditing Investment Activity.** The auditor should test investment activity by obtaining an analysis of the change in the investments during the period under audit and by examining authorizations and documentation supporting purchases, sales, and realized gains and losses.

Transaction testing by examination of documents at the plan location usually is possible for nontrusted investments or for investments in nondiscretionary trusts. Audit sampling may be necessary in testing investment transactions if there are numerous investment transactions during the year and gives guidance on the type of audit sampling that would be used.

In auditing investment transactions, the auditor should determine that the trade date is used to record purchases and sales. If the settlement date is used, the auditor should determine that unrecorded transactions made just before the financial statement date do not significantly affect the composition of the plan’s assets and that their fair value has not changed from the trade date to the financial statement date.

**Auditing Investment Income.** Analytical procedures can be effective for testing investment income, such as comparing investment income and investment yield (ratio of income by category of investment to the average current value during the year by category) for the current and prior year and to industry indexes for similar types of investments. Another analytical procedure is to recompute income for specific investments by applying dividend or interest rates to average investment balances outstanding during the period.

The auditor should determine that dividends declared close to the financial statement date are recorded as of the ex-dividend date and not the record or payment date, and that any necessary interest or dividends are accrued.

**Auditing Investment Valuation.** With the exception of plan investments in unallocated insurance contracts, GAAP requires employee benefit plan investments to be presented at fair value. Thus, the auditor should test investment
valuation and the calculation of the unrealized gain or loss during the period. Audit procedures to test fair value are relatively simple if the investments have a quoted market price. Fair value may be determined by reference to market quotations. The auditor can refer to the last sales or bid price of stocks and bonds, or net asset value of mutual fund shares, published in market listings of publicly traded securities and mutual funds.

Investments that do not have a readily available market price include restricted or unregistered securities, securities with a thin market, interests in limited partnerships or LLCs, real estate, and mortgages. Such investments may include employer securities held by an ESOP established by a small, closely held company. Restricted securities and other investments without a ready market must be valued in good faith by the plan’s board of trustees, administrative committee, or a specialist engaged by the plan to make the valuation. IRC provisions require ESOPs to obtain independent appraisals of certain employer securities that are not readily tradeable on an established securities market.

In auditing the fair valuation, the auditor does not act as an appraiser, but reviews and assesses the reasonableness and appropriateness of the plan’s valuation methods and underlying data and assumptions. Based on AEBP, Paragraph 7.16h, and other generally accepted auditing procedures, the auditor may consider the following procedures:

- Determine and evaluate the plan’s valuation methods and procedures and whether they are specified by GAAP and whether they were followed.
- Test underlying data and assumptions supporting the estimates.
- Inquire whether the plan’s board of trustees, administrative committee, or other designated party has reviewed and approved the valuation estimates. Read supporting minutes or other documentation evidencing such review and approval and the fair valuation determined.
- Follow the SAS No. 73 (AU 336) requirements if the plan engaged a specialist to value the investments or if the auditor considers a specialist necessary to help audit the plan’s valuation.
- If the fair value of investments is used to determine compensation for the investment manager (or equivalent) and the compensation is material, perform adequate testing of the fair values to support the compensation testing.

AEBP, Paragraph 7.16h, cautions that confirming the fair values of investments with a plan’s trustee, custodian, or investment manager does not constitute valuation testing. Independent corroboration of fair values is required even if the confirmation includes fair values. Similarly, AICPA Auditing Interpretation No. 1 of SAS No. 92 (AU 9332.01—.04), Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist, states a confirmation from a third party containing fair values is not sufficient audit evidence with regard to the valuation assertion in SAS No. 92. However, there can be situations when a confirmation with a third party containing fair values may provide sufficient audit evidence about valuation. FASB ASC No. 2009-12, Fair Value Measurements and Disclosures (Topic 820)—Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), amends FASB ASC 820-10 (formerly SFAS No. 157) to provide reporting entities a practical means of measuring the fair value of alternative investments, such as hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds, that do not have readily determinable fair values because they are not publicly traded. The investee may provide the reporting entity with a net asset value per share (or its equivalent, for example, member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) as of the reporting entity’s measurement date that has been calculated at fair value in a manner consistent with GAAP for investment companies. When this is the case, the reporting entity is allowed to value the alternative investment on the basis of the net asset value per share provided by the investee as of the reporting entity’s measurement date without further adjustment. These amendments apply only if the alternative investment does not have a readily determinable fair value and is in an entity that has the following attributes:

- Its primary business activity is investing, usually in the securities of other entities not under common management, for current income, appreciation, or both.
- Ownership in the entity is represented by units of investments, such as shares of stock or partnership interests, to allow the attribution of proportionate shares of net assets.
• It allows its owners to pool their funds for professional investment management.

• The entity is the primary reporting entity.

If the preceding conditions are not met, the reporting entity is required to consider whether an adjustment to the net asset value per share is necessary to estimate the fair value of the investment. Adjustments may be necessary when the net asset value per share (or its equivalent) provided by the investee does not represent the fair value of the reporting entity’s investment in all circumstances. For example, restrictions on redemption at the measurement date and transaction prices from principal-to-principal or brokered transactions may indicate that adjustments are necessary. Also, the amendments do not apply to portions of investments the reporting entity will probably sell at amounts that differ from the net asset value per share (or its equivalent). The amendments in ASC No. 2009-12 are effective for periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued.

SAS No. 101 (AU 328), Auditing Fair Value Measurements and Disclosures, establishes standards and provides guidance on auditing fair value measurements and disclosures in financial statements. It does not address specific types of assets, liabilities, transactions, or industry-specific practices and does not amend or supersede any existing SASs. According to SAS No. 101, the auditor should perform the following steps when auditing fair value measurements and disclosures:

• Obtain an understanding of the process for determining fair value measurements and disclosures and the related internal controls, and assess risk.
• Evaluate whether fair value measurements conform to GAAP.
• Consider the need for a specialist.
• Test the fair value measurements.
• Evaluate whether fair value disclosures conform to GAAP.
• Evaluate the results of audit procedures.
• Obtain management representations about fair value measurements and disclosures.
• Make appropriate communications with those charged with governance.

Understanding the Process and Assessing Risk. AEBP, paragraph 2.10, notes that meeting the requirements of FASB ASC 820 (formerly SFAS No. 157) requires coordination among plan management, custodians, investment fiduciaries, and plan auditors, and that plan sponsors and administrators need to determine whether they have the appropriate valuation processes and sufficient data to determine the fair value of the plan’s investments and related disclosures in accordance with the framework and requirements provided in FASB ASC 820 (formerly SFAS No. 157). The auditor should obtain an understanding of the plan’s process for determining fair value measurements and disclosures and of the related controls sufficient to develop an effective audit approach. The auditor obtains this understanding by considering matters such as:

• Controls over the measurement and disclosure process and the underlying data.
• The experience and expertise of those involved, including whether specialists or service organizations are used. AEBP, paragraph 2.10, states that even though plan management can outsource the mechanics of the valuation process, management needs to retain responsibility for the oversight of the final valuations and adequacy of related disclosures.
• The application of information technology in the process.
• The significant assumptions used and the documentation supporting them.
• The process used to develop, apply, and monitor changes in assumptions.
The auditor then assesses the risk of material misstatement in fair values by considering the complexity of the related accounting and reporting requirements. Risk generally increases along with complexity. The auditor’s risk assessment affects the nature, timing, and extent of audit procedures.

Evaluating Measurements for Conformity with GAAP. In determining whether the fair value measurements conform to GAAP, the auditor should consider the following:

- Plan management’s intent and ability to carry out specific courses of action, where relevant.
- When a valuation method is used, the appropriateness of the method, including plan management’s rationale for choosing the method and whether plan management has determined the range of values resulting from different methods and investigated the reasons for the differences.
- Whether the fair values have been determined consistently and if, in the case of changing circumstances, they should be.

Engaging a Specialist. The auditor should assess the need to use a specialist to evaluate fair value measurements and disclosures. If an auditor plans to use a specialist, the auditor should consider whether the specialist’s understanding of the definition of fair value and the method to be used to determine fair value are consistent with those of the plan’s management and GAAP. The auditor should also understand the assumptions and methods used by the specialist.

Testing Fair Value Estimates. The auditor should use his or her assessment of the risk of material misstatement and understanding of the fair value measurement process to determine the nature, timing, and extent of audit procedures to perform. To obtain evidence supporting a fair value estimate, the auditor may consider the following approaches:

- Test the client’s valuation, including significant assumptions, the valuation model, and the underlying data.
- Develop an independent estimate and compare it to the client’s valuation.
- Review subsequent events and transactions to corroborate the client’s valuation. However, the auditor should only consider those events or transactions that reflect circumstances existing at the financial statement date.

According to AICPA Auditing Interpretation No. 1 of SAS No. 101 (AU 9328.01–.04), Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value, receiving a confirmation from a trustee is not adequate audit evidence regarding the fair value of an interest in a trust held by a third-party trustee according to the provisions of SAS No. 101.

When testing the client’s valuation or developing an independent estimate based on plan management’s assumptions, the auditor should evaluate whether those assumptions are reasonable and consistent with market information. The auditor should also consider the source and reliability of evidence supporting the assumptions, paying special attention to assumptions that are highly sensitive and susceptible to misapplication or bias. Consideration should also be given to the sensitivity of the valuation to changes in assumptions and market conditions. To be reasonable, the assumptions, individually and taken as a whole, need to be realistic and consistent with the following:

- Economic and market information.
- The plan’s objectives, including plan management’s expectations regarding the outcome of specific plans and strategies.
- Prior period assumptions, if appropriate.
- Past experience of the plan, as applicable.
• Other matters relating to the financial statements, for example assumptions used in accounting estimates for other financial statement accounts unrelated to fair value.

• Risk associated with cash flows, if applicable, including the potential variability in amount and timing and the related effect on the discount rate.

The accuracy, completeness, and relevancy of the underlying data should be tested, and the auditor should ensure the resulting valuation properly reflects both the assumptions and the data. Tests may include verifying the source of the data, recomputing, and reviewing information for internal consistency.

If the auditor independently develops assumptions for use in evaluating the client’s estimate, he or she should understand plan management’s assumptions to assess whether any significant matters have been omitted and to evaluate any significant differences between plan management’s and the auditor’s estimates. This evaluation should also be performed if a valuation specialist develops the fair value estimate.

Evaluating Disclosures for Conformity with GAAP. To evaluate whether fair value disclosures are adequate and conform to GAAP, the auditor should:

• Obtain evidence that the method of estimation is appropriate under GAAP and applied consistently.

• Consider whether the method of estimation and significant assumptions are adequately disclosed.

• Assess whether the disclosures are sufficient to inform users of the degree of measurement uncertainty.

• Evaluate the adequacy of disclosure when fair value information is omitted because it is not practical to determine fair value with sufficient reliability.

Other Procedures. During summarization and evaluation procedures, the auditor should evaluate the sufficiency and competence of the evidence obtained and its consistency with other evidence obtained during the audit. Regardless of the audit approach used, the auditor should ordinarily obtain management representations about the reasonableness of significant assumptions. The auditor might also obtain representations about the appropriateness and consistency of the valuation method used, the completeness and adequacy of disclosures, and whether subsequent events require adjustment to the fair value measurements or disclosures. Furthermore, the auditor should determine that those charged with governance are informed about plan management’s process for developing sensitive fair value estimates and about the basis for the auditor’s conclusions regarding their reasonableness.

Considering Liens and Pledges on Investments. An employee benefit plan may have pledged investments. For example, real estate held as an investment may secure a mortgage loan. A leveraged ESOP pledges stock of the employer entity to collateralize debt incurred to acquire that employer stock. The auditor should consider whether there are any liens, pledges, or other security interests on investments by inquiry of the plan administrator and by review of information on confirmations, minutes, loan agreements, etc.

Considering Compliance with ERISA and Plan Provisions. The auditor should also consider whether the investments comply with requirements of ERISA and the plan documents. ERISA requires that fiduciaries diversify plan investments to minimize risk. ERISA also prohibits plans from selling, exchanging, or leasing property, or extending credit, to parties in interest, or acquiring qualifying employer securities or qualifying employer real estate, as defined, exceeding, at the time of acquisition, 10% of the fair value of plan assets. The U.S. Supreme Court has held that the contribution of real property to a qualified benefit plan to satisfy the minimum required plan contribution is a prohibited transaction and, therefore, is subject to an excise tax under IRC Section 4975. The ruling does not prohibit the contribution of real property to plans that have no minimum contribution requirements. For plans with minimum requirements, if the employer meets the minimum requirement with a cash contribution, additional contributions including real property may be made up to the maximum deduction limit. ERISA requires disclosure of prohibited transactions and certain other matters such as loans or leases in default and transactions, or a series of transactions, exceeding 5% of the current value of the plan’s assets. In addition, the plan documents or minutes of the administrative or investment committee may specify an investment policy or prohibit or limit certain types of investments.
The auditor should determine that investment transactions were properly authorized and not in violation of plan provisions or investment policies. He or she should consider whether transactions involved parties in interest, resulted in excess holdings of employer securities or real estate, or exceed the threshold for a reportable transaction. These considerations can be made when reviewing the analysis of investment activity and when examining supporting documents for specific transactions during the audit of investments. The auditor should also ask plan personnel whether any transactions involved parties in interest, violated ERISA requirements, plan provisions, investment policy, or require reporting in supplemental schedules accompanying the financial statements.

The auditor should review the list of investments and consider whether it reflects undue investment concentration that might be considered a violation of the ERISA diversification requirement.

**Auditing Investments Held in a Discretionary Trust**

When investments are held in a discretionary trust, the trustee has authority to initiate investment transactions within the framework specified in the trust agreement without specific authorization of individual transactions. Usually, the plan administrator’s only records of investment transactions and balances are those that the trustee has provided, and the plan administrator may not have documents supporting specific transactions. Thus, the auditor may not be able to obtain an independent record of investment transactions and balances at the plan location, yet cannot rely solely on the trustee’s report for evidential matter.

A service auditor’s SAS 70 report may allow the plan auditor to use the trust department’s report of plan transactions as evidential matter. AEBP, Paragraph 7.19, states that obtaining and using a service auditor’s SAS 70 report is an example of a substantive procedure to be applied when transactions are executed by the discretionary trust.

If the plan auditor concludes that it is necessary to obtain information on the service organization’s accounting procedures that is relevant to the plan’s internal control, the information may be obtained by using a service auditor’s SAS 70 report or by applying the necessary procedures at the trust department. If a service auditor’s SAS 70 report is not available and the auditor is unable to perform or have another CPA perform the necessary procedures, the plan auditor ordinarily will have to qualify or disclaim an opinion on the plan’s financial statements because of the scope limitation.

AEBP, Paragraph 7.19, states that ordinarily the plan auditor need not review the trust department auditor’s workpapers related to the service auditor’s SAS 70 report if he or she is satisfied about that auditor’s professional reputation and independence.

**Auditing Investments in Common/Collective Trusts**

A common/collective trust involves the pooling of assets of two or more unrelated plans at a bank or similar financial institution for investment purposes. The bank does not own the assets in the trust but only holds them in trust for the participating plans. Each participating plan owns units of participation in the fair value of the assets underlying the trust. Many common/collective trusts issue audited financial statements.

The plan auditor’s procedures for investments held in common/collective trusts may include confirming the plan’s units of participation with the trustee and examining the plan’s approvals and other documents supporting the plan’s transactions in the units of participation during the period (for instance, investment committee minutes, trust agreements, and investment guidelines).

The auditor may also obtain a copy of the current financial statements of the trust, if available, and consider the reasonableness of unit information in those statements in comparison to unit information recorded by the plan. Information to consider includes market values, purchase and sales values, and income earned and accrued. AEBP, Paragraph 7.22c, indicates that, in examining documents supporting the unit value information, the procedures the auditor may consider performing differ depending on whether the trust’s financial statements have been audited by an independent auditor. If audited financial statements are available, the auditor may obtain and read the financial statements and auditor’s report. AEBP, Paragraph 7.22c, states that the financial statements should be recent, but need not be for the exact period as the plan’s statements. A period within three to six months of the date of the plan’s statements is considered reasonable.
Also, the plan auditor may consider the effect on the units’ carrying value of any matters reported in the trust’s financial statements, such as restriction on redemption or subjectively determined values. AEBP, Paragraph 7.22c, suggests that if the plan auditor believes that the units’ carrying value may be impaired, he may consider applying analytical procedures to the trust’s subsequent interim financial statements to determine if the units have suffered a loss in value.

If audited financial statements of the trust are not available, AEBP, Paragraph 7.22c indicates the auditor may consider the guidance in AICPA Auditing Interpretation No. 1 in AU section 328 (AU 9328.01–.04), Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value, and the AICPA Practice Aid, Alternative Investments—Audit Considerations (A practice aid for auditors). This guidance includes considering actual transactions in the units at or near the financial statement date and reviewing and testing the significant assumptions and data used by the financial institution to value the units.

If the auditor is unable to perform the auditing procedures described in this section, a qualification or disclaimer of opinion on the plan’s financial statements may be necessary because of the scope limitation.

Auditing Investments in Mutual Funds

Investments in registered investment companies, commonly referred to as mutual funds, have grown dramatically in the past 20–25 years, especially in profit sharing plans and 401(k) plans. In addition, technology of third-party administrators or service divisions of mutual fund companies allow participants to initiate automated transactions, such as electing and changing investment options, by telephone, the Internet or an Intranet, leaving no “paper trail” for the plan.

The audit procedures may be applied to investments in mutual funds. In addition, if “paperless transactions” occur, as described in the preceding paragraph, the auditor should consider performing one or more of the following procedures:

- If available, obtain a service auditor’s SAS 70 report on the internal controls relevant to aspects of the mutual funds. Consider the results discussed in the report and the type of report in determining the extent of substantive procedures to be performed.
- Confirm account balances and/or individual transactions, such as transfers or contributions, with individual participants.

Auditing Investments in Master Trusts

Master trusts are similar to common/collective trusts, except that the plans participating in the trust are sponsored by a single employer or by members of a controlled group of companies.

If the master trust issues audited financial statements, the plan auditor may choose to review them. If the plan auditor also audits the master trust, the basic auditing procedures may be applied. If the trustee for the master trust has discretionary control over the trust’s assets, the procedures for a discretionary trust may be applied.) Then, the allocation of the ownership to the participating plans may be tested based on the provisions of the master trust instrument or the agreement of the administrators of all the participating plans. If audited financial statements of the master trust are not available, the plan auditor may perform the procedures necessary to obtain sufficient audit evidence to support the financial statement assertions relevant to the investments in the master trust. The auditor should also be familiar with the fair value measurement disclosure requirements for master trusts. If the plan auditor is unable to perform the necessary procedures, the plan auditor may have to qualify or disclaim an opinion on the plan’s financial statements because of the scope limitation.

DOL Limited-scope Audits. If a DOL limited-scope audit is being performed on a plan with an investment in a master trust or a similar arrangement, the plan administrator should obtain from the trustee or custodian of the master trust a certification of the investments and related activity attributable only to that plan. For example, if three plans (Plan A, Plan B, and Plan C) invest in Master Trust I, the certification from the trustee or custodian of Master Trust I to the administrator of Plan A should only cover the investments and related activity attributable to Plan A rather than the investments and activity of the Master Trust I, which would include all three plans.
Auditing Investments in Omnibus Accounts

Employee benefit plans may have investments in omnibus accounts. *Omnibus accounts* are institutional accounts in which transactions are made for a number of beneficial owners, such as employee benefit plans, combined for trading purposes. Those transactions are subsequently allocated to the beneficial owners. Omnibus accounts may be held in the name of a custodian bank or an investment advisor and may use an affiliated recordkeeper to document the activity of individual owners within the account. AEBP Paragraph 7.27, suggests auditors may consider performing the following steps when auditing investments in omnibus accounts:

- Obtain a confirmation from the transfer agent of the overall values of each investment fund holding at the omnibus level at the end of the period.
- For each investment fund held by the plan, review a period-end reconciliation of the combined balances of all plans participating in the fund to the omnibus account of the transfer agent and test reconciling items as necessary.
- For each investment fund, agree the plan’s balances as reported by the recordkeeper to the balances in the listing of participating plans at the end of the period.
- Test the investments’ fair values by comparing each investment fund holding’s net asset value at the omnibus level to audited financial statements or market quotations.
- Analytically review changes in the fair value of the investment in the omnibus account through comparison to overall changes in the fair value of the investment fund as reported in financial statements or other sources of published information.
- If available, obtain a Type II service auditor’s SAS 70 report for the recordkeeper or transfer agent, and consider any applicable information presented in the report about the omnibus account and reconciliation procedures. If service auditor’s SAS 70 reports are not available, consider confirming transactions at the omnibus level with participating plans, tracing transactions per the recordkeeper’s or transfer agent’s records to the statements of the omnibus account investment fund, and/or testing other transactions at the omnibus account level.

Auditing Other Investments

Other investments that employee benefit plans may own include real estate, mortgages, limited partnership interests, loans, etc. Plans may engage real estate management companies and mortgage servicing agents to manage those investments. The same basic auditing procedures discussed herein are appropriate for other investments. Specific considerations in applying those procedures to particular types of other investments follow.

**Real Estate.** For real estate, evidence of existence and ownership that the auditor may examine includes deeds, title policies, closing documents, and leases. Also, the auditor can compare property descriptions in real estate tax bills for the current year to the property recorded in the plan’s financial statements. When examining documents pertaining to real estate, the auditor should be alert for indications of liens, pledges, or other security interests.

Real estate income can be tested analytically by comparing amounts to prior year amounts and by recomputing rental income based on rates in leases. The auditor should determine that rental income is accrued if necessary. Expenses such as maintenance and property taxes may be reviewed for reasonableness, analytically tested, related to tax bills and agreements with management agents, etc.

Real estate usually is not readily marketable. Thus, the auditor may evaluate the fair valuation of real estate by methods discussed herein. The auditor should consider whether the fair valuation gave appropriate consideration to a possible decline in the property’s value. If the plan engages an appraiser to value its real estate, the auditor should test the data provided to the specialist for reasonableness and consider the appraiser’s objectivity and relationship to the plan. Sometimes a plan’s professional real estate manager also appraises the property it manages (or engages the appraiser) and bases its management fee on the property’s value. The auditor may have concerns about the objectivity of a real estate valuation made under such circumstances and may need to apply
additional procedures to the appraiser’s assumptions, methods, or findings, or engage another appraiser, to determine that the appraisal is not unreasonable.

In addition, the auditor should consider whether sales of real estate investments are properly classified in the plan’s financial statements. According to an AICPA Technical Practice Aid at TIS 6931.03, the sale by an employee benefit plan of a real estate investment that generates rental income and operating expenses for the plan should not be reported as a discontinued operation. Although employee benefit plans are not specifically scoped out of FASB ASC 205-20 (formerly SFAS No. 144) and investments in real estate may meet the GAAP definition of a component of an entity, employee benefit plan financial statements do not include a statement of operations or activities. Therefore, it is not necessary to distinguish between continuing and discontinued operations. Real estate investments should be reported at fair value and any related income, expenses, net appreciation, or net depreciation should be reported in the statement of changes in financial status or the statement of changes in net assets available for benefits.

ERISA prohibits real estate transactions with parties in interest and limits plan acquisition of employer real estate. The auditor should apply the procedures described herein to determine possible violations of ERISA or other requirements.

**Limited Partnerships.** The auditor may test investments in limited partnerships for evidence of existence and ownership by examining limited partnership agreements, minutes from meetings of the plan’s management or the limited partnership, and copies of the financial statements of the limited partnership, if available. Consideration may also be given to confirming the plan’s investment with the investment manager or advisor of the limited partnership.

An investment in a limited partnership is generally difficult to value. The plan auditor may obtain and review audited financial statements of the limited partnership, if available, and consider the reasonableness of the limited partnership’s value in those statements to the investment valuation included in the plan’s financial statements. Information to consider includes purchase and sales values, income earned and accrued, and appraisals, if available.

If audited financial statements are not available for the limited partnership or such statements are inadequate, the plan auditor should perform additional procedures. In addition to the basic auditing procedures discussed herein, AEBP, Paragraph 7.60 lists the following procedures the auditor may consider performing:

- Obtain and review information regarding the investment holdings of the limited partnership. Discuss with the limited partnership’s management the methods used to value the investments.
- Perform valuation procedures or review copies of appraisals, if available. The auditor should consider the guidance in SAS No. 73 (AU 336), *Using the Work of a Specialist*.
- Assess the control risk related to the limited partnership. A service auditor’s SAS 70 report may be useful in making this assessment.

AEBP, Paragraph 7.60, indicates that the trustee or custodian may not have timely or accurate information regarding the amount and valuation of investments in limited partnerships. In those situations, the auditor may need to perform additional procedures.

Auditors should also be aware that the financial statements or appraisal prepared for a limited partnership may be as of a different year end than that of the plan. The AICPA Audit Risk Alert, *Employee Benefit Plans Industry Developments—2006*, indicates the financial statements or appraisal do not have to cover the exact period covered by the plan’s financial statements but should be sufficiently recent to satisfy the auditor. Auditors may consider performing additional procedures to address the gap in reporting periods such as—

- Requesting information about the partnership’s monthly financial activity since the date of the financial statements or valuation and performing substantive analytical procedures.
- Asking the investment adviser about monthly valuation procedures and any unusual investment activity which may significantly impact market value.
- Assessing the need to obtain additional evidence to determine the investment’s fair value.
Mortgages and Loan Investments, Including Participant Loans. These types of investments include mortgages and loans to third parties and loans to plan participants. Evidence about the existence and terms of such investments is obtained by examining mortgage, loan, and note agreements, deeds, and insurance policies supporting the investments. The amounts and terms of significant loans and mortgages should be confirmed with the borrowers.

If the plan uses a mortgage servicing agent, the auditor should consider obtaining a service auditor’s SAS 70 report on the servicing agent’s controls or applying procedures at the servicing agent’s location. The auditor may also consider the agent’s financial condition by inquiring about the adequacy of its bonding and insurance coverage and by reviewing any available audited financial statements. The auditor may consider the accounting for any escrow accounts the servicing agent may maintain.

Mortgage and loan interest income can be tested analytically on an overall basis by relating income to average loan or mortgage balances outstanding during the period or by applying interest rates in loan or mortgage agreements to the balances. The auditor should determine that appropriate interest accruals are made, if necessary.

The auditor should consider the collectibility of loan and mortgage receivables and the need for, and adequacy of, an allowance for uncollectible balances. The auditor should also consider the existence and adequacy of related collateral.

The fair value of mortgages and loans may be audited. Fair value of mortgages and loans will generally be based on discounted cash flows of comparable loans. Auditors should be aware that plans may carry participant loans at amortized cost, which may or may not be representative of fair value. If participant loans are carried at amortized cost, auditors may request the plan administrator to assess the fair value of the loans.

The auditor should consider whether any loans or mortgages violate ERISA, tax, or plan provisions. For example, the plan document must authorize loans to participants, and the loans must bear a reasonable rate of interest and be adequately secured. Also, individual income tax rules treat the portion of loans that exceed certain limits or that are not repaid within a specified time as a distribution to the plan participant. (For GAAP purposes, however, the plan document provides the guidance to determine whether delinquent loans should be reclassified as distributions.) The auditor should also consider whether there are any matters that ERISA requires to be disclosed, for instance, loans in default.

Nonpublicly-traded Stock and Employer Securities. For nonpublicly-traded stock and employer securities, evidence of existence and ownership may be tested by physical count or confirmation of the trustee or custodian. In addition to confirmations, minutes from meetings and agreements may be reviewed for the existence of liens, pledges, or other security interests on investments.

The fair value of nonpublicly-traded stock and employer securities should be audited in accordance with SAS No. 57 (AU 342), Auditing Accounting Estimates and SAS No. 101 (AU 328), Auditing Fair Value Measurements and Disclosures. The IRC requires independent appraisals of certain employer securities acquired by an ESOP. Also, if a plan has significant investments in nonpublicly-traded stock and employer securities without a ready market value and the fair value is determined by plan management, the auditor may decide it is necessary to use the work of a specialist to test management’s valuation. If a specialist is used, the auditor should test the underlying data provided to the specialist and review the specialist’s qualifications, reputation, and relationship to the client.

When testing investment transactions in nonpublicly-traded stocks and employer securities, the auditor may verify proper authorization, examine appropriate supporting documentation such as cash records, and agree the purchase or sale prices to supporting documentation such as valuation information provided by a specialist at or near the trade date.

Derivatives. FASB ASC 815 (formerly SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities), as amended, provides disclosure requirements for derivative financial instruments and nonderivative instruments that are designated and qualify as hedging activities.

Some employee benefit plans use derivative instruments as part of their investment portfolios. When they are material, derivatives present unique auditing considerations to practitioners due to the complex nature of derivative transactions and the accounting rules that apply to them.
Key considerations when auditing derivatives and hedging activities include:

a. Identifying derivative instruments.

b. Evaluating whether derivative instruments are properly designated as hedging instruments and, if so, the type of hedge.
   - For derivatives designated as a hedge, evaluating whether the entity has assessed the effectiveness of the hedging relationship when financial statements are prepared (or at least every three months).
   - For a fair value hedge, evaluating whether the changes in fair value of the hedged item are properly accounted for.

c. Evaluating whether derivative instruments are properly valued at fair value and assessing the proper treatment of changes in fair value.

The first step in auditing derivatives is to assess whether all derivative instruments have been identified by the plan’s management and recorded in the plan’s financial statements. The auditor may use inquiries of plan management and reviews of the plan’s financial records to identify derivative instruments. However, auditors should not focus exclusively on evidence relating to cash receipts and disbursements when designing tests for completeness because derivatives may not involve an initial net investment. Common procedures performed to identify derivative instruments include:

a. Inquiry of the plan’s management to determine if the plan has entered into any contracts that meet the definition of a derivative. The auditor should gain an understanding of the extent of derivative use, the types of derivatives used, the plan’s purpose in using derivatives, and plan management’s control over derivative transactions.

b. Requesting information regarding the existence of derivatives with counterparties who are frequently used, but with whom the plan’s accounting records indicate there are currently no derivatives.

c. Inspecting documentation for activity after year end that may indicate the existence of derivatives at year end.

d. Inspecting financial instruments and other agreements for embedded derivatives and determining whether they should be accounted for separately from the host contract.

e. Reading other information such as the minutes of administrative or investment committees, or board of trustees.

After identifying financial instruments subject to the accounting and reporting provisions of FASB ASC 815 (formerly SFAS No. 133) the auditor may consider the following common audit procedures to validate the completeness and accuracy of amounts, if any, recorded in the plan’s financial statements:

a. Physically inspecting the derivative contract.

b. Requesting information from the counterparty to an identified derivative. The auditor may inquire regarding the significant terms of the derivative and the nature and existence of any settled and unsettled transactions.
between the plan and the counterparty. Auditors should also consider confirming with counterparties the derivative activity during the year. Any activity confirmed may be reviewed and compared with the description of the plan’s use of derivatives provided by plan management to their description.

c. For derivative instruments designated as a hedge, the auditor should inspect management’s documentation of the hedging relationship to determine that the derivative qualifies for hedge accounting. The auditor should also verify the timeliness of the documentation of the hedging relationship. For derivatives designated as hedges, the plan must comply with specific documentation requirements at the inception of the hedge.

d. Reading and inspecting any related agreements, underlying agreements, and other forms of documentation for amounts reported, unrecorded repurchase agreements, and other evidence.

e. Testing and assessing the reasonableness of the fair value of the derivative. The fair value of derivatives may be based on quoted market prices, fair value estimates from broker-dealers or other third-party sources, or determined by the plan’s management using a valuation model. If the fair value is obtained from a third-party source, such as a pricing service, the guidance in SAS No. 70 (AU 324), Service Organizations, may apply. If the third-party source derives fair value by using modeling or similar techniques, the guidance in SAS No. 73 (AU 336), Using the Work of a Specialist, may apply. If the plan determines the fair value by using a modeling technique, procedures the auditor may perform to assess the reasonableness of the fair value include:

- Assessing the reasonableness and appropriateness of the model. For example, determining whether the market variables and other assumptions used are reasonable.

- Calculating the fair value using a model developed by the auditor or a specialist to develop an independent expectation to corroborate the reasonableness of the plan’s valuation.

- Comparing the fair value with recent or subsequent transactions.

- For changes in fair value during the period, considering whether the changes are properly recorded in the plan’s financial statements.

The guidance in SAS No. 101 (AU 328), Auditing Fair Value Measurements and Disclosures, should be considered when auditing fair value of derivatives.

f. Testing to ensure that derivative transactions are initiated within the guidelines established by the plan’s management and documented in its investment policies.

Self-directed Investment Programs. In addition to participant-directed programs, some plans allow participants to self-direct their account balances in any investment that they desire, subject to certain limitations. The auditor should review the underlying investments in any self-directed account and determine the appropriate audit procedures to perform to adequately test those investments.

If the auditor plans to rely on a service auditor’s SAS 70 report with regard to the testing of self-directed investment programs, the auditor should ensure that the report addresses the self-directed investment program. The AICPA Audit Risk Alert, Employee Benefit Plans Industry Developments—2007, indicates service auditor’s SAS 70 reports often do not address such self-directed investments. Further, the Audit Risk Alert suggests auditors obtain a reconciliation of the balances of self-directed investments per the plan’s trustee or custodian to the amounts reported in the plan’s financial statements.
SELF-STUDY QUIZ

6. If an employee benefit plan has a third-party plan administrator, the records pertaining to the plan’s investments are most likely to be located in which of the following locations?
   a. In the plan’s safe deposit box at a bank.
   b. In a vault at the plan or plan sponsor’s location.
   c. In a location off premises.

7. The auditor should confirm the plan’s investments as of the financial statement date by examining evidence of ownership on hand at the plan that takes the form of any of the following except:
   a. Stock certificates.
   b. Investments on hand at the plan for the previous financial statement date.
   c. Deeds for real estate owned by the plan.
   d. Confirmation of investments with the custodian.

8. When auditing investment transactions, the auditor should determine that which of the following dates was used to record purchases and sales?
   a. Payment date.
   b. Trade date.
   c. Settlement date.

9. Kara has been engaged to audit the employee benefit plan of KLZ, Inc. The plan includes publicly traded securities, interests in limited partnerships, real estate and unregistered securities. Which of the following is correct for Kara’s audit procedures regarding the investments?
   a. Kara will need to review the financial statements of the limited partnerships that the plan has an interest in to determine its value.
   b. Kara would need to operate as an appraiser on investments that do not have a readily available valuation that she can obtain.
   c. Kara should value all investments at the price that the plan paid for the investments.
   d. Kara should determine the value of the publicly traded securities by referring to the quoted market price.

10. Valuation testing requires confirming the fair values of investments with which of the following?
    a. A plan’s trustee.
    b. An independent party.
    c. A custodian.
    d. Investment manager.
11. When auditing fair value measurements and disclosures, which of the following does not apply?
   a. The auditor should understand the plan’s process for determining fair value measurements and disclosures.
   b. The auditor should assess the risk of material misstatement in fair values based on the complexity of the related accounting/reporting requirements.
   c. The auditor should consider plan management’s intent and ability to carry out specific courses of action.
   d. The auditor should always perform his or her own evaluation of fair value measurements and disclosures.

12. When seeking evidence supporting a fair value estimate, the auditor may consider any of the following approaches except:
   a. Test the client’s valuation.
   b. Develop an independent estimate.
   c. Review subsequent events regardless of whether the circumstances existed at the date of the financial statements.

13. Which of the following statements regarding the auditor’s responsibilities is accurate?
   a. The auditor is not responsible for determining whether investment transactions have been properly authorized.
   b. The auditor does not need to determine whether transactions result in excess holdings of employer securities.
   c. The auditor is responsible for determining whether the list of investments reflects excessive investment concentration that could be a violation of ERISA diversification requirements.
   d. The auditor is responsible for auditing plan investments in a DOL limited-scope audit.

14. Which of the following accurately describes an auditor’s responsibilities when auditing mortgages and loan investments?
   a. The terms of significant loans and mortgages need not be confirmed with the borrowers.
   b. If the plan uses a mortgage servicing agent, the auditor does not need a service auditor’s SAS 70 report.
   c. If a mortgage servicing agent is used by the plan, the auditor does not need to consider the servicing agent’s financial condition.
   d. The auditor should consider the collectibility of loan and mortgage receivables.

15. Which of the following Statements on Auditing Standards (SAS) does not address auditing the fair value of nonpublicly-traded stock and employer securities?
   a. SAS No. 57.
   b. SAS No. 92.
   c. SAS No. 101.
16. Which of the following procedures would be used to assess the reasonableness of the fair value of derivatives recorded in the plan’s financial statements?

a. Inquiry of the plan’s management.

b. Inspecting documentation for activity after year end.

c. Assessing the reasonableness and appropriateness of the model.

d. Inspecting financial instruments.
SELF-STUDY ANSWERS

6. If an employee benefit plan has a third-party plan administrator, the records pertaining to the plan’s investments are most likely to be located in which of the following locations? (Page 158)

   a. In the plan’s safe deposit box at a bank. [This answer is incorrect. It is very uncommon for records pertaining to the plan’s investments to be kept in a safe deposit box at a bank since their security is not that vital.]

   b. In a vault at the plan or plan sponsor’s location. [This answer is incorrect. Records pertaining to the plan’s investments are rarely kept in a vault at the plan or plan sponsor’s location since most documents could be reproduced, therefore, the security of the documents is not critical.]

   c. In a location off premises. [This answer is correct. Records dealing with the plan’s investments are generally located off premises, especially if the plan has a third-party plan administrator since they are primarily responsible for the daily management of the plan.]

7. The auditor should confirm the plan’s investments as of the financial statement date by examining evidence of ownership on hand at the plan that takes the form of any of the following except: (Page 159)

   a. Stock certificates. [This answer is incorrect. Stock certificates are one example of evidence of ownership on hand of the plan’s investments.]

   b. Investments on hand as of the previous year’s financial statement date. [This answer is correct. Investments on hand as of the previous year’s financial statement date may indicate a pattern of investments and ownership on hand, but should not be a basis for confirming the plan’s investments as of the current financial statement date.]

   c. Deeds for real estate owned by the plan. [This answer is incorrect. Deeds for real estate owned by the plan is another example of evidence of ownership on hand of the plan’s investments.]

   d. Confirmation of investments with the custodian. [This answer is incorrect. One way the auditor can confirm the plan’s investments as of the financial statement date is by confirming those investments with the custodian.]

8. When auditing investment transactions, the auditor should determine that which of the following dates was used to record purchases and sales? (Page 160)

   a. Payment date. [This answer is incorrect. The payment date has no bearing on, and should not be used by the auditor to record purchases and sales when auditing investment transactions.]

   b. Trade date. [This answer is correct. It is preferable, and the auditor should determine that the trade date is used to record purchases and sales so that the correct value is assigned to the investment.]

   c. Settlement date. [This answer is incorrect. In the event the settlement date is used, the auditor should confirm that unrecorded transactions made just prior to the financial statement date do not have a significant effect on the composition of the plan’s assets and that their fair value has not changed from the trade date to the financial statement date.]

9. Kara has been engaged to audit the employee benefit plan of KLZ, Inc. The plan includes publicly traded securities, interests in limited partnerships, real estate and unregistered securities. Which of the following is correct for Kara’s audit procedures regarding the investments? (Page 160)

   a. Kara will need to review the financial statements of the limited partnerships that the plan has an interest in to determine their value. [This answer is incorrect. Investments without a ready market must be valued in good faith by the plan’s board of trustees, administrative committee, or specialist engaged by the plan to make the valuation. Kara would not need to determine the value of the interest herself.]
b. Kara would need to appraise investments that do not have a readily available valuation. [This answer is incorrect. In auditing the fair valuation, the auditor does not act as an appraiser, but reviews and assesses the reasonableness and appropriateness of the plan’s valuation methods and underlying data and assumptions.]

c. Kara should value all investments at the price that the plan paid for the investments. [This answer is incorrect. GAAP requires employee benefit plan investments to be presented at fair value, not at the price paid for the investment.]

d. Kara should determine the value of the publicly traded securities by referring to the quoted market price. [This answer is correct. Audit procedures to test fair value are relatively simple if the investments have a quoted market price. Fair value may be determined by reference to market quotations. Publicly traded securities would have a quoted market price.]

10. Valuation testing requires confirming the fair values of investments with which of the following?

a. A plan’s trustee. [This answer is incorrect. According to SAS No. 92, confirming the fair values of investments with a plan’s trustee does not establish valuation testing.]

b. An independent party. [This answer is correct. Even if the fair values of investments are confirmed with the plan’s trustee, corroboration of fair values with an independent party is required in order to qualify as adequate valuation testing.]

c. A custodian. [This answer is incorrect. The requirements of valuation testing are not met by confirming the fair values of investments with a custodian since it does not provide sufficient audit evidence.]

d. Investment manager. [This answer is incorrect. Valuation testing results cannot be relied on by confirming the fair values of investments with an investment manager. Confirmation from a third party does not provide sufficient audit evidence per SAS No. 92.]

11. When auditing fair value measurements and disclosures, which of the following does not apply?

a. The auditor should understand the plan’s process for determining fair value measurements and disclosures. [This answer is incorrect. According to SAS No. 1, the auditor should understand the plan’s process for determining fair value measurements and disclosures and of the related controls. The auditor gains this understanding by considering a variety of things such as the application of information technology in the process.]

b. The auditor should assess the risk of material misstatement in fair values based on the complexity of the related accounting/reporting requirements. [This answer is incorrect. The auditor should assess the risk of material misstatement in fair values based on the complexity of the related accounting/reporting requirements per SAS No. 101. Risk usually increases in conjunction with complexity. Risk assessment affects the nature, timing, and extent of audit procedures.]

c. The auditor should consider plan management’s intent and ability to carry out specific courses of action. [This answer is incorrect. The auditor should consider plan management’s intent and ability to carry out specific courses of action, whenever relevant as explained in SAS No. 101. The auditor should also consider other things such as whether the fair values have been determined consistently and if they should be.]

d. The auditor should always perform his or her own evaluation of fair value measurements and disclosures. [This answer is correct. The auditor should examine the possible need to use a specialist to evaluate fair value measurements and disclosures. If using a specialist is planned by the auditor, the auditor should determine whether the specialist’s understanding of the definition of fair value and the method to be used to determine fair value are consistent with the methods used by the plan’s management and GAAP.]
12. When seeking evidence supporting a fair value estimate, the auditor may consider any of the following approaches except: (Page 163)

a. Test the client’s valuation. [This answer is incorrect. When seeking evidence supporting a fair value estimate, the auditor may consider testing the client’s valuation, including significant assumptions, the valuation model, and underlying data.]

b. Develop an independent estimate. [This answer is incorrect. When seeking evidence supporting a fair value estimate, the auditor may develop an independent estimate and compare it to the client’s valuation to assess the risk of material misstatement and understand the fair value process.]

c. Review subsequent events regardless of whether the circumstances existed at the date of the financial statements. [This answer is correct. When seeking evidence supporting a fair value estimate, the auditor may consider reviewing subsequent events, but only those events that reflect circumstances existing at the financial statement date.]

13. Which of the following statements regarding the auditor’s responsibilities is accurate? (Page 165)

a. The auditor is not responsible for determining whether investment transactions have been properly authorized. [This answer is incorrect. The auditor is responsible for determining that investment transactions have been properly authorized and are not in violation of plan provisions or investment policies per ERISA requirements.]

b. The auditor does not need to determine whether transactions result in excess holdings of employer securities. [This answer is incorrect. According to ERISA, the auditor should determine whether transactions involved parties in interest, result in excess holdings of employer securities or real estate, or exceed the threshold for a reportable transaction.]

c. The auditor is responsible for determining whether the list of investments reflects excessive investment concentration that could be a violation of ERISA diversification requirements. [This answer is correct. The auditor should review the list of investments to make sure there is compliance with ERISA and determine whether it reflects excessive investment concentration that could be considered a violation of the diversification requirement established by ERISA.]

d. The auditor is responsible for auditing plan investments in a DOL limited-scope audit. [This answer is incorrect. No audit procedures are applied to plan investments in a limited-scope audit that is certified as complete and accurate by the plan’s trustee.]

14. Which of the following accurately describes an auditor’s responsibilities when auditing mortgages and loan investments? (Page 169)

a. The terms of significant loans and mortgages need not be confirmed with the borrowers. [This answer is incorrect. The terms and amounts of significant loans and mortgages should be confirmed with the borrowers to make sure they are recorded properly.]

b. If the plan uses a mortgage servicing agent, the auditor does not need a service auditor’s SAS 70 report. [This answer is incorrect. The auditor should consider acquiring a service auditor’s SAS 70 report on the servicing agent’s controls or applying procedures at the servicing agent’s location when the plan uses a mortgage servicing agent.]

c. If a mortgage servicing agent is used by the plan, the auditor does not need to consider the servicing agent’s financial condition. [This answer is incorrect. The auditor should consider the agent’s financial condition by investigating the adequacy of its bonding and insurance coverage and also by reviewing any available audited financial statements.]

d. The auditor should consider the collectibility of loan and mortgage receivables. [This answer is correct. The auditor should consider the collectibility of loan and mortgage receivables and the need
for an allowance for uncollectible balances to make sure they are valued properly. The existence and adequacy of related collateral should also be considered by the auditor.]

15. Which of the following Statements on Auditing Standards (SAS) does not address auditing the fair value of nonpublicly-traded stock and employer securities? (Page 169)

a. SAS No. 57. [This answer is incorrect. The fair value of nonpublicly-traded stock and employer securities should be audited in accordance with one of two SAS documents, one being SAS No. 57, *Auditing Accounting Estimates*.]

b. SAS No. 92. [This answer is correct. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, is not used when auditing the fair value of nonpublicly-traded stock or employer securities. SAS No. 92 provides guidance for auditing financial instruments that meet the definition of a derivative or a hedge in FASB ASC 815.]

c. SAS No. 101. [This answer is incorrect. The fair value of nonpublicly-traded stock and employer securities should be audited in accordance with one of two SAS documents, one is SAS No. 101, *Auditing Fair Value Measurements and Disclosures*.]

16. Which of the following procedures would be used to assess the reasonableness of the fair value of derivatives recorded in the plan’s financial statements? (Page 170)

a. Inquiry of the plan’s management. [This answer is incorrect. A procedure is performed to identify derivative instruments. An inquiry of the plan’s management is used to determine if the plan has entered into any contracts that meet the definition of a derivative in FASB ASC 815.]

b. Inspecting documentation for activity after year end. [This answer is incorrect. Inspecting documentation for activity after year end is a procedure used to identify derivative instruments and may indicate the existence of derivatives at year end.]

c. Assessing the reasonableness and appropriateness of the model. [This answer is correct. One example of a procedure the auditor may perform to assess the reasonableness of the fair value is to assess the reasonableness and appropriateness of the model such as when the auditor determines whether the market variables and other assumptions used are reasonable as stated in SAS No. 73.]

d. Inspecting financial instruments. [This answer is incorrect. Another procedure performed to identify derivative instruments is the inspection of financial instruments and other agreements for embedded derivatives and determining whether they should be accounted for separately from the host contract.]
CONTRACTS WITH INSURANCE COMPANIES

Many retirement and health and welfare benefit plans enter into contracts with insurance companies. These contracts may be investment vehicles or a means of transferring some or all benefit obligations to an insurance company. This section discusses different types of contracts for retirement plans and for health and welfare benefit plans.

Allocated Contracts

Insurance company contracts entered into by retirement plans may be broadly classified as allocated or unallocated. With an allocated contract, payments to the insurance company are used to purchase insurance or annuity contracts for specific individual plan participants. The following types of insurance or annuity contracts may be purchased:

- Individual ordinary life insurance policies, which use the policy’s cash surrender value at the participant’s retirement date to purchase a retirement annuity.
- Individual annuity contracts.
- Group permanent insurance contracts, which are similar to individual insurance policies, except that a group policy covering more than one plan participant is purchased. Each participant receives a certificate indicating his benefits under the group plan.
- Deferred group annuity contracts, which buy deferred annuities equal to the benefits each participant in the group has accrued at the date of purchase. Additional units are purchased for each participant as plan benefits accrue.

With an allocated contract, the plan benefits are fully guaranteed by the insurance company, which has a legal obligation to make the benefit payments to the participants covered by the allocated contract. Under GAAP and Form 5500 reporting requirements, allocated contracts and the related benefit obligations are excluded from the plan’s financial statements because the purchase of the contract transfers the obligation to pay the benefits and the related risks to the insurance company. Pension Benefit Guaranty Corporation (PBGC) insurance does not cover such annuity contracts. Retirement plans whose only assets are insurance contracts that fully guarantee the payment of benefits are exempt from the audit requirement.

Unallocated Contracts

Unallocated contracts are contracts under which payments to the insurance company are not allocated to specific individual plan participants, but are held in an undivided fund for investment until they are used to pay benefits or to buy annuities for plan participants who retire or terminate employment with vested benefits. It is important to realize that an unallocated contract is only an investment vehicle and does not transfer any benefit obligation or related risk from the plan to the insurance company. (The only things that may be “insured” are a rate of return on the investment or a rate at which annuities may be purchased, if the contract guarantees a return or annuity purchase rate.) Thus, the term “insurance contract” can be misleading with respect to unallocated contracts. A better term might be “investment contract with an insurance company.” Unallocated contracts are included in the plan’s financial statements and include the following:

- Deposit administration (DA) contracts.
- Immediate participation guarantee (IPG) contracts.
- Guaranteed investment contracts (GIC).
- Synthetic GICs.
- Individual (separate) separate accounts.
- Pooled separate accounts.

These types of unallocated contracts are discussed in the following paragraphs.
Deposit Administration (DA) Contract. In a DA contract, current contributions are not immediately applied to the purchase of single-payment deferred annuities for individual participants but instead are credited to an account for the plan. As participants retire, annuities are purchased with funds from the account. (Other incidental benefits, such as death, disability, and withdrawal, may also be disbursed directly and charged to the account.) Earnings on the account are also credited to the account. For investment purposes, the balance in the account (contributions and earnings not yet used to pay benefits or to purchase annuities) is commingled with other assets of the insurance company.

The account is credited with interest at the rate specified in the contract. Although the insurance company may guarantee a minimum interest rate that will be credited back to the account and the rates at which the annuities may be purchased, the insurance company does not generally guarantee that the account will have sufficient funds to cover the cost of the annuities when the time comes to purchase them. Thus, the plan generally retains an obligation for benefits promised under a defined benefit plan if the funds in the DA account are not sufficient.

Under DA contracts, rate credits or experience-rated interest credits (referred to as credits in this paragraph) are determined solely by the insurance company. Such credits are not guaranteed, and there is no contractual obligation that they be paid (or credited). The credits, if paid, are based on the actual investment experience of the company. A plan has no contractual right to an accounting or access to the calculations supporting the amounts. Such amounts may be paid, credited to the account referred to above, or considered in an overall dividend calculation that takes into account mortality, other actuarial experience, and the insurance reserve requirements of the company. As with the rate credits, the company is under no obligation to pay dividends.

Immediate Participation Guarantee (IPG) Contract. An IPG contract is similar to a DA contract, except that the insurance company does not guarantee a minimum interest rate on the account. Instead, the account is credited with interest equal to the insurance company’s actual investment experience.

Another difference is that when a specific individual plan participant retires, benefits may be paid directly from the account instead of by purchasing an annuity. Also, the insurance company does not guarantee the rate at which annuities may be purchased (if that option is chosen), but charges the insurance company’s actual experience rate for annuities at the time of purchase. The account is also charged for contract administration expenses.

An IPG contract may be a general account, with the underlying assets being commingled with the insurance company’s other assets, or it may be an individual or pooled separate account. Also, as with a DA contract, the insurance company does not guarantee that the account will be sufficient to meet all plan benefits. The insurance company is generally obligated only for the benefits under any annuities purchased for retired or terminated plan participants from the account.

Guaranteed Investment Contract (GIC). A GIC may be used as part of a DA or IPG contract or may be separately maintained. A guaranteed investment contract is an investment vehicle that guarantees a return on principal invested in the account over a specified period. Various types of GICs may allow additions or withdrawals during certain periods of the contract life, may have multiple maturities and interest rates, may have floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the insurance company’s discretion.

GICs normally are general accounts that are backed only by the general assets of the insurance company (although some insurance companies have introduced separate account GICs, which are backed by assets held in a separate account). Plan sponsors and participants have been concerned about the safety of GICs due to financial difficulties experienced by some insurance companies. Many plans have not renewed GICs that have matured, have switched to stronger insurance companies, or have stopped buying new GICs. These developments have audit implications—the auditor of a plan that owns GICs reported at contract value in the plan’s financial statements should consider whether information about the issuing insurance company suggests that the contract should be reported at less than contract value.

Some sponsors of defined contribution plans have previously reimbursed the plan for any losses suffered on GICs purchased from insurance companies that subsequently failed, even though in defined contribution plans, participants bear the risk of any plan investment losses. Also, even though participants of defined contribution plans bear investment losses (rather than the plan sponsor), plan fiduciaries could still be held liable for losses if it were decided that their choice of an insurance company was imprudent under ERISA’s fiduciary requirements.
**Synthetic GIC.** A synthetic GIC has many of the characteristics of a GIC. The primary difference is the underlying assets of a synthetic GIC are owned by the plan (or by a trust owned by the plan), whereas the underlying assets of a GIC are owned by the issuer of the investment contract. The underlying assets often include government securities, investment-grade corporate obligations, and mortgage-backed or other asset-backed securities. A synthetic GIC also contains a “wrapper” contract, which the plan purchases from a third party (often the same entity that issues the investment contract). The “wrapper” contract protects the plan from the risk of declines in the market value and cash flow potential of the covered assets. Because the plan may liquidate the underlying assets to make distributions or fund other cash needs, the risk protection provided by the “wrapper” contract is important.

**Individual (Separate) Separate Account.** An individual separate account (also called a separate-separate account) is one of two types of separate account investment vehicles at an insurance company (the other type is a pooled separate account). An individual separate account is similar to a discretionary trust at a bank. A single plan participates in the account. The investment assets are owned by the insurance company but are separately identified and are not commingled with the company’s other assets.

**Pooled Separate Account.** A pooled separate account is similar to a common/collective trust, except that a pooled separate account is at an insurance company rather than at a bank. Also, the assets underlying a pooled separate account are the insurance company’s property, with each of the two or more unrelated participating plan’s units of participation representing rights to the assets underlying the separate account.

**Summary of Allocated and Unallocated Insurance Contracts**

Exhibit 1-1 summarizes the types of allocated and unallocated insurance contracts discussed in the preceding paragraphs.

---

**Exhibit 1-1**

**Types of Investment and Insurance Contracts**

<table>
<thead>
<tr>
<th>Allocated Contract</th>
<th>Unallocated Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(excluded from plan statements)</em></td>
<td><em>(included in plan statements)</em></td>
</tr>
</tbody>
</table>

- Insurance policies or annuity contracts are purchased for individual plan participants, and the insurance company assumes the obligation to pay their benefits and the related risks. Types include:
  - Individual ordinary life insurance policy.
  - Individual annuity contract.
  - Group permanent insurance policy covering more than one participant.
  - Deferred group annuity contract covering accrued benefits of more than one participant.

- Payments to the insurance company are investment vehicles and are not allocated to specific individual plan participants. The insurance company does not guarantee any benefits from the account.

  **Deposit Administration (DA) Contract**—specifies a rate of interest and a rate at which annuities may be purchased from the account. May be a general account or separate account.

  **Immediate Participation Guarantee (IPG) Contract**—does not guarantee an interest rate or a rate at which annuities may be purchased from the account. May be a general account or a separate account.

  **Guaranteed Investment Contract (GIC)**—an investment vehicle that guarantees a rate of return on the principal invested and does not subject the insurance company to risks arising from policyholder mortality or morbidity. Normally is a general account.

  **Synthetic GIC**—similar to GICs, except the plan or a trust owns the underlying assets of the investment contract. A “wrapper” contract protects the plan from market value fluctuations.
Allocated Contract
(excluded from plan statements)

Unallocated Contract
(included in plan statements)

General Account—the assets are commingled with the insurance company’s other assets.

Separate Accounts—discretionary type investment vehicles, with the insurance company owning the assets but separately identifying them with the separate account:

- Individual (separate) separate account—assets of one plan are invested.
- Pooled separate account—assets of two or more unrelated plans are invested, with each plan having units of participation.

*         *         *

This section refers only to insurance companies, but similar considerations apply to similar contracts at noninsurance companies. In addition, some defined contribution plans invest in common/collective trusts that in turn invest in contracts with insurance companies and/or GICs. AEBP Paragraph 7.47 indicates determining whether the plan’s investment is a common/collective trust or an account established to hold investment or insurance contracts specifically for one plan takes careful consideration.

Basic Auditing Procedures for All Types of Contracts

In auditing contracts, the first step is to read the contract to determine its nature and terms, for instance, whether the account is allocated or unallocated; guarantees interest rates or not; and is a general account or separate (individual or pooled) account. The auditor should note whether the contract is with an insurance company or other financial institution, since, in some instances, this determines whether it should be valued at contract or fair value.

The auditor should consider whether provisions in the contract that restrict the use of assets (for example, termination clauses that assess a penalty against contract value for premature termination or withdrawals) require adjustment or disclosure in the plan’s financial statements. The auditor may also read the financial statements of the insurance company and consider its responsibility and financial capability. AEBP Paragraph 7.50c, cautions the auditor to consider any events or conditions related to the insurance company that may require financial statement disclosure or cause plan management to conclude that an adjustment should be made to the contract’s reported value. For investment contracts issued by troubled insurance companies, the auditor should consider whether the accounting or disclosure requirements of FASB ASC 450 (formerly SFAS No. 5, Accounting for Contingencies), and the disclosure requirements of FASB ASC 275 (formerly SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties), may apply. Considerations include whether interest should continue to be accrued on such contracts, whether there is a probable and estimable loss on the contract that should be recorded, or whether a possible loss or an inestimable (and therefore unrecorded) probable loss should be disclosed in the financial statements.

The auditor may confirm with the insurance company information such as the contract or fair value, as appropriate; contributions and premiums paid into the contract account during the period; interest, dividends, and experience-rated credits credited to the contract during the period; annuities purchased or benefits paid from unallocated contracts during the period; management fees and other expenses charged to the contract during the period; and any transfers between various funds and accounts.

If management fees and other expenses charged to the contract are significant, the auditor may examine documents supporting the charges and relate them to the terms of the contract.
The auditor should consider whether the contracts or transactions in them violate requirements, limitations, or prohibitions of ERISA or the plan.

**Auditing Contract Valuation.** Certain contracts with insurance companies must or are permitted to be carried at fair value (rather than contract value). Generally such contracts do not have a readily available market. Generally these bases can also be applied to contracts and include the selling prices of similar investments and the expected cash flow discounted at a rate commensurate with the risk involved. Often the insurance company can provide an appropriate fair value. In these instances, it is suggested the auditor also inquire as to the method used by the insurance company to determine the fair value and consider the appropriateness of the methods.

**Limited-scope Audit.** In a DOL limited-scope audit, no procedures are applied to information on contracts maintained as investment vehicles (separate and pooled accounts, DA and IPG contracts, and GICs), and related transactions, that are prepared and certified to as both complete and accurate by the financial institution or insurance company. In a DOL limited-scope audit, the auditor’s responsibilities for contracts with insurance contacts covered by the limited-scope exception are the same as those for other investments.

**Additional Procedures for Deposit Administration (DA) Contracts**

Deposit administration (DA) contracts guarantee a rate of interest and a rate at which benefit annuities may be purchased with funds from the account. A DA contract may be a general account, in which the assets in the contract are commingled with the insurance company’s other assets, or it may be an individual or pooled separate account.

Auditing procedures specific to DA accounts in addition to the basic auditing procedures for all types of insurance contracts include evaluating the reasonableness of interest credited to the account in relation to any minimum rate guaranteed in the contract.

The auditor may also compare rates paid for any annuities purchased from the contract fund with rates guaranteed in the contract. He or she may also test any benefits paid from the fund; this can be done as part of the test of benefit payments.

**Additional Procedures for Immediate Participation Guarantee (IPG) Contracts**

Immediate participation guarantee (IPG) contracts may be a general account or a separate account and are similar to DA contracts described above, except that IPGs do not guarantee a minimum interest rate or a rate for purchasing annuities from the fund. Those rates are based on the insurance company’s actual investment experience or annuity experience rate at the time interest is credited to the account or annuities are purchased.

Because IPG contracts do not specify an interest rate, in addition to the basic procedures discussed above, the auditor may refer to investment yield information provided to the plan by the insurance company to test the reasonableness of interest credited to the IPG contract. AEBP Paragraph 7.51b, indicates that an evaluation of the yield information from the insurance company is usually all that the auditor needs to do if the yield appears reasonable. However, if the income does not appear reasonable, the auditor may ask the insurance company whether the method used to calculate investment return for purposes of crediting it to the contract complies with the method specified in the contract. If necessary, the auditor may consider arranging for the insurance company’s auditor to apply agreed-upon procedures to the insurance company’s determination of investment income credited to the contract and issue a report in accordance with SSAE No. 10 (AT 201), *Agreed-upon Procedures Engagements*, as amended.

The rates paid for any annuities purchased from the contract’s funds may be traced to the rates in the annuity contracts, and any benefits paid from the contract may be tested as part of auditing benefit payments.

**Additional Procedures for Guaranteed Investment Contracts (GIC)**

A guaranteed investment contract normally is a general account that guarantees a rate of return on the principal invested. Various types of GICs may have multiple maturities and interest rates, may have floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the insurance company’s discretion. Thus, in addition to the basic procedures discussed above, the auditor may evaluate the reasonableness of interest credited to the contract in relation to any minimum guaranteed interest rate stated in the contract.
Additional Procedures for Synthetic GICs

In synthetic GICs, the assets underlying the contract are placed in a trust and are owned by the plan rather than the contract issuer. The plan purchases a “wrapper” contract from a third party (often the same entity that issues the investment contract), which protects the plan from the risk of declines in the market value and cash flow potential of the covered assets. The underlying assets and the “wrapper” contract are to be separately valued and included in the “Schedule of Assets (Held at End of Year)” in the Form 5500. Thus, in addition to the basic procedures discussed above, the auditor may also test the fair values of the underlying assets and the value of the “wrapper” contract to be disclosed in the supplemental schedule.

Additional Procedures for Separate-separate Accounts

Separate-separate accounts are similar to discretionary trust accounts described herein. The separate account pertains to a single plan. The account’s investment assets are owned and managed by the insurance company, but they are separately identified within the separate account and are not commingled with the insurance company’s other assets.

Audit procedures include testing transactions and testing any benefits paid directly from the account. In addition, the audit procedures for discretionary trusts discussed above are also appropriate for separate-separate accounts. That is, the auditor may read audited financial statements of the separate account if they are available. If they are not available, he or she may obtain and use a service auditor’s SAS 70 report on the insurance company’s controls over the separate account’s activities (including controls over the determination of unit values and over share transactions), or apply procedures at the insurance company if a service auditor’s SAS 70 report cannot be obtained.

Additional Procedures for Pooled Separate Accounts

Pooled separate accounts are similar to common/collective trusts described herein, except that pooled separate accounts are at insurance companies instead of financial institutions. Unlike a separate-separate account, a pooled separate account pertains to two or more unrelated plans. Each participating plan’s units of participation represent rights to the separate account assets. (The assets are the insurance company’s property but are not commingled with its other assets.)

Audit procedures include testing transactions in units of participation and testing any benefits paid directly from the account. In addition, pooled separate accounts may be audited similarly to common/collective trusts. That is, the auditor may be able to use the audited financial statements of the separate account or may have to perform alternative procedures if audited financial statements of the account are not available.
SELF-STUDY QUIZ

17. Which of the following is classified as an allocated contract?

   a. Deposit administration contract.
   b. Immediate participation guarantee contract.
   c. Guaranteed investment contract.
   d. Deferred group annuity contract.

18. When auditing contracts, all of the auditing procedures below should be followed by the auditor except:

   a. The auditor needs to determine whether contract provisions that restrict the use of assets require adjustment or disclosure in the plan’s financial statements.
   b. The auditor should rely on the insurance company to provide a written statement that affirms its responsibility and financial capability.
   c. The auditor should confirm with the insurance company, management fees and other expenses charged to the contract during the period.
   d. The auditor should consider whether the contracts violate requirement, limitations, or prohibitions of ERISA.

19. Kimberly is auditing the deposit administration contracts of an employee benefit plan for WellsSpring Financial. Which of the following is an audit procedure that Kimberly should perform on the contracts?

   a. Kimberly should analyze the fair values of the underlying assets disclosed in the supplemental schedules.
   b. Kimberly should test the rate of return on investments, for reasonableness against the interest credited to the IPG contract.
   c. Kimberly should compare the reasonableness of interest credited to the account to the minimum rate guaranteed in the DA contract.

20. Under which of the following contracts are payments to insurance companies not allocated to specific individual plan participants?

   a. Individual ordinary life insurance policy.
   b. Individual annuity contract.
   c. Synthetic guaranteed investment contract.
   d. Group permanent insurance contract.

21. Which of the following types of contracts does not guarantee a minimum interest rate?

   a. Deposit administration (DA) contracts.
   b. Immediate participation guarantee (IPG) contracts.
   c. Guaranteed investment contracts (GIC).
22. A characteristic of a separate-separate account is a single plan with account investments being owned and managed by an insurance company and separately identified within the separate account and not commingled with the insurance company’s other assets. A separate-separate account shares this characteristic with what other type of account?

   b. Master trusts.
   c. Discretionary trusts.
   d. Mutual funds.
SELF-STUDY ANSWERS

17. Which of the following is classified as an allocated contract? (Page 180)

a. Deposit administration contract. [This answer is incorrect. A deposit administration contract is a type of unallocated contract whereby current contributions are not immediately applied to the purchase of single-payment deferred annuities for individual participants but rather are credited to an account for the plan.]

b. Immediate participation guarantee contract. [This answer is incorrect. An immediate participation guarantee contract is a type of unallocated contract. With this type of contract, the insurance company does not guarantee a minimum interest rate on the account but rather the account is credited with interest equal to the insurance company’s actual investment experience.]

c. Guaranteed investment contract. [This answer is incorrect. A guaranteed investment contract is a type of unallocated contract and a type of investment that guarantees a return on principal invested in the account over a specified period.]

d. Deferred group annuity contract. [This answer is correct. A deferred group annuity contract is a type of allocated contract that purchases deferred annuities equal to the benefits each participant in the group has accrued at the date of purchase. Additional units are purchased for each participant as plan benefits accrue.]

18. When auditing contracts, all of the auditing procedures below should be followed by the auditor except: (Page 183)

a. If the contract provisions that limit the use of assets, the auditor needs to determine whether an adjustment or disclosure in the plan’s financial statements is required. [This answer is incorrect. It is important for the auditor to determine if contract provisions that restrict the use of assets require adjustment or disclosure in the plan’s financial statements to assure the plan’s financial status is presented fairly at the financial statement date. An example would be termination clauses that assess a penalty against the value of the contract for premature withdrawals or termination.]

b. The auditor should rely on the insurance company to provide a written statement that affirms its responsibility and financial capability. [This answer is correct. The auditor should read the financial statements of the insurance company to determine its responsibility and financial capability and not rely on the insurance company to provide the affirmation. AEBP, Paragraph 7.50c cautions the auditor to consider any events or conditions related to the insurance company that may required financial statement disclosure or cause plan management to conclude that an adjustment should be made to the contract’s reported value.]

c. The auditor may confirm with the insurance company, management fees and other expenses charged to the contract during the period. [This answer is incorrect. The auditor may confirm with the insurance company, management fees and other expenses charged to the contract during the period, contract or fair value, as appropriate, and contributions and premiums paid into the contract account during the period, among others. Significant fees should be audited to make sure they are valid.]

d. The auditor may consider whether the contracts violate requirements, limitations, or prohibitions of ERISA. [This answer is incorrect. The auditor should determine whether the contracts or transactions in them violate requirements, limitations, or prohibitions of ERISA or the plan when auditing the contracts so that all contracts will be in compliance with ERISA.]

19. Kimberly is auditing the deposit administration contracts of an employee benefit plan for WellsSpring Financial. Which of the following is an audit procedure that Kimberly should perform on the contracts? (Page 184)

a. Kimberly should analyze the fair values of the underlying assets disclosed in the supplemental schedules. [This answer is incorrect. In a deposit administration contract, the assets in the contract are commingled
with the insurance company’s other assets and may be individual or pooled in separate accounts. The fair value of the underlying assets would be tested if the contract was placed in a trust and is owned by the plan, such as in a synthetic GIC.]

b. Kimberly should test the rate of return on investments, for reasonableness against the interest credited to the IPG contract. [This answer is incorrect. An auditor should test the reasonableness of interest credited to the IPG contract when the plan is part of an immediate participation guarantee to make sure that the rate is in compliance with the contract.]

c. Kimberly should compare the reasonableness of interest credited to the account to the minimum rate guaranteed in the DA contract. [This answer is correct. Auditing procedures specific to DA accounts, in addition to the basic auditing procedures for all types of insurance contracts, include evaluating the reasonableness of interest credited to the account in relation to any minimum rate guaranteed in the contract to make sure the plan is receiving the most benefit from the contract.]

20. Under which of the following contracts are payments to insurance companies not allocated to specific individual plan participants? (Page 184)

a. Individual ordinary life insurance policy. [This answer is incorrect. An individual ordinary life insurance policy is a type of allocated contract that uses the policy’s cash surrender value at the participant’s retirement date to purchase a retirement annuity.]

b. Individual annuity contract. [This answer is incorrect. An individual annuity contract is a type of allocated contract.]

c. Synthetic guaranteed investment contract. [This answer is correct. A synthetic guaranteed investment contract is similar to a guaranteed investment contract and is also an unallocated contract. With a synthetic guaranteed investment contract, the underlying assets are owned by the plan, or by a trust owned by the plan.]

d. Group permanent insurance contract. [This answer is incorrect. A group permanent insurance contract is a type of allocated contract similar to individual insurance policies with the exception that a group policy covering more than one plan participant is purchased.]

21. Which of the following types of contracts does not guarantee a minimum interest rate? (Page 184)

a. Deposit administration (DA) contracts. [This answer is incorrect. DA contracts guarantee a minimum rate of interest and a rate that can be used to purchase benefit annuities with funds from the account.]

b. Immediate participation guarantee (IPG) contracts. [This answer is correct. Under the terms of the contract, IPGs do not guarantee a rate for purchasing annuities from the fund or a minimum interest rate.]

c. Guaranteed investment contracts (GIC). [This answer is incorrect. Various types of GICs can have multiple maturities and interest rates, floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the discretion of the insurance company.]

22. A characteristic of a separate-separate account is a single plan with account investments being owned and managed by an insurance company and separately identified within the separate account and not commingled with the insurance company’s other assets. A separate-separate account shares this characteristic with what other type of account? (Page 185)

a. Common/collective trusts. [This answer is incorrect. A common/collective trust involves the pooling of asset of two or more unrelated plans at a financial institution such as a bank or investment purposes.]

b. Master trusts. [This answer is incorrect. Plans participating in a master trust are sponsored by a single employer or by members of a controlled group of companies.]
c. Discretionary trusts. [This answer is correct. With discretionary trusts, the trustee has the authority
to initiate investment transactions within the guidelines specified in the trust agreement without
specific authorization of individual transactions. The separate account relates to a single plan. The
account’s investment assets are owned and managed by the insurance company, but they are
identified separately within the separate account and are not commingled with the insurance
company’s other assets.]

d. Mutual funds. [This answer is incorrect. Mutual funds are funds invested in registered investment
companies where participants can initiate automated transactions that leave no paper documentation for
the plan.]
PARTICIPANT DATA

Participant data includes information such as age, sex, hire date, salary, service years, hours worked in the current period, etc. It should be audited because it is used in determining material amounts presented in the financial statements. This section also discusses audit procedures for employee contributions since such contributions are usually made by payroll deductions and may be conveniently audited along with other payroll data.

Participant data is used in accruing benefits in a defined benefit retirement plan. For example, a defined benefit plan may provide for benefit accruals as a specified percentage of a participant’s salary for each year of employment. (Determining accumulated plan benefits is a preliminary step to determining the actuarial present value of accumulated plan benefits reported in defined benefit plan financial statements.)

A defined contribution plan may provide for an employer’s contribution equal to a specified percentage of each participant’s salary. The total of all such determined contributions would be reported in the plan’s financial statements.

Participant data is often used in determining health and welfare benefits. For example, the number of dependents may affect the participant’s contribution for health insurance, age may effect the participant’s contribution for life insurance, and hire date may affect vacation accruals.

In addition to its use in determining amounts presented in the plan financial statements, participant data is used in determining the individual participant account balances that ERISA requires defined contribution plans to maintain. Such account balances may be used to allocate total plan contributions, income and losses, and forfeitures to individual participants and record individual participant activity such as a participant’s own contributions.

If the plan auditor also audits the plan sponsor’s (employer’s) financial statements, the plan auditor may be able to coordinate with, and rely on, work performed during the plan sponsor’s audit. This is especially helpful as it relates to pension demographic data and health and welfare benefit plan participant data (including claims data), and postretirement benefit obligation actuarial valuations. For example, if the plan sponsor’s payroll system was evaluated as effective, and was tested during the plan sponsor’s audit by tracing information to the original records, such as personnel files, the plan auditor could trace participant data to the payroll records previously tested rather than original records. If another auditor audits the plan sponsor (especially for multiemployer plans), the plan auditor may be able to arrange for the other auditor (or auditors) to apply agreed-upon procedures during the audit of the employer’s payroll costs and to issue a report in accordance with SSAE No. 10, Attestation Standards: Revision and Recodification, as amended.

If the auditor tested participant data in the prior year, consideration may be given to carrying forward this work to the current year audit and each subsequent audit. For example, demographic data such as plan participant name, hire date, birth date, and sex would only need to be tested for current year additions and deletions. If the plan auditor’s firm also audits the plan sponsor’s financial statements, participant payroll data could be updated each year by reviewing payroll journals rather than original records, if tested by the auditor, as described above.

The plan auditor should keep in mind that if the benefit information date for a defined benefit retirement plan is as of the beginning of the plan year, the participant data should also be as of the beginning of the plan year. This date corresponds to the plan sponsor’s prior year end. Thus, the plan auditor may be able to refer to the prior year’s audit workpapers of the plan sponsor.

Basic Auditing Procedures for Participant Data

The first step in auditing participant data is to determine by reviewing the plan documents (and collective bargaining agreements for multiemployer plans) what data is pertinent and thus will have to be tested. For example, service years or hours would be relevant if the plan accrues benefits or determines eligibility for benefits based on the number of service years or hours. This preliminary step can be performed during the review of minutes, plan documents, contracts, and agreements at the start of the audit.

The auditor may test the employer’s payroll journal and, if considered necessary, trace gross pay postings to the employer’s general ledger. He or she may test payroll data for one or more payroll periods for a number of
participants by tracing payroll data to and from participants’ earnings records; tracing pay rates to authorizations or union contracts; tracing hours worked to time cards, production records, etc.; and recalculating earnings for the period. Demographic data, such as birth and hire dates, sex, termination dates, number of dependents, investment election, etc., may be traced to personnel files. Sampling is likely and efficient in testing payroll transactions and demographic data.

**Employee Contributions.** If the plan document calls for voluntary or mandatory employee contributions, auditing procedures include tracing the basis for the employee contribution to the plan document, collective bargaining agreement, or employee authorization, recomputing the tested individuals’ contribution deduction in the payroll journal when testing the payroll journal, and tracing contributions to and from the individual participant accounts. If the plan provides for participant-directed investment programs, the auditor should determine that the tested individuals’ contribution was allocated in accordance with the individuals’ investment option(s) election. The auditor may also trace contributions to the plan’s cash receipts or trustees reports and to the recording in the plan’s general ledger and records of employee contributions received.

In recent years, many plan sponsors have added an automatic enrollment feature to their plans so that eligible employees are automatically enrolled in the plan at a specific pretax contribution percentage, unless they take the appropriate action to opt out. For those plans, auditors need to understand the enrollment process and the opt out action, and be aware of the rules surrounding automatic enrollment.

The auditor may consider confirming employee contributions with the employees.

Finally, the auditor should determine that all employee contributions attributable to the period under audit have been received by the plan or accrued as a receivable. Many employers withhold employee contributions from the employee’s payroll check and remit the total contribution for all employees to the plan. DOL Regulation 2510.3-102 requires employers to remit the employee contributions to the plan as soon as they can be reasonably segregated from the employer’s general assets.

The DOL recently revised DOL Reg. 2510.3-102 to provide a safe harbor for plans with fewer than 100 participants at the beginning of the plan year and to extend the requirements to participant loan repayments. Under the safe harbor, as long as amounts are deposited with a plan no later than the 7th business day after the date on which the amounts were either received by the employer or such amounts would otherwise have been payable to the participant in cash, the amounts are considered contributed or repaid to the plan on the earliest date such amounts could reasonably be segregated from the employer’s general assets. The safe harbor is optional for small plans and no safe harbor exists at this time for large plans (those with 100 or more participants). However, the DOL may consider a safe harbor for large plans in the future.

Although under DOL Reg. 2510.3-102, the general rule is that amounts a participant or beneficiary pays to an employer or amounts that a participant has withheld from his wages by an employer become plan assets on the earliest date on which those contributions or repayments can reasonably be segregated from the employer’s general assets, the DOL regulation includes the following maximum time limits for transmitting funds to an employee benefit plan:

- For most pension benefit plans, including defined contribution and defined benefit retirement plans, amounts must be transmitted to the plan no later than “the 15th business day of the month following the month in which the participant contribution or participant loan repayment amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant’s wages).”

- For SIMPLE plans with SIMPE IRAs, amounts must be transmitted to the plan no later than the 30th calendar day after the month in which the amounts would otherwise have been payable in cash to the participant.

- For welfare benefit plans, the date can be no later than 90 days from when the amounts are received by the employer or when such amounts would otherwise have been payable in cash to the participant.

The regulation includes provisions by which pension plans may receive an extension of the maximum time period in certain circumstances.
This regulation continues to be an area of concern for the DOL. Employee Benefit Security Administration (EBSA) officials continue to stress that employee contributions are due to the plan “as soon as they can be reasonably segregated” from the employer’s general assets. In a recent question and answer session, EBSA officials suggested auditors compare the timeliness of the employer’s remittance of participant contributions to the plan to the timeliness of the employer’s remittance of FICA and FIT withholdings to appropriate sources.

If the employer does not comply with the regulation, such occurrences are considered a prohibited transaction, regardless of materiality. In addition, EBSA officials have stated that a prohibited transaction would occur if the employer normally remits the participant contributions to the plan within five days of being withheld (demonstrating the time the contributions can be reasonably segregated), but one time during the year remits the contributions 15 days after being withheld. The 15 and 90 day maximum periods for remittance are not safe harbors for large plans. In other words, plan sponsors (and auditors) should not assume contributions are in compliance with the regulations so long as they are remitted prior to the 15 or 90 day limit. The defining characteristic is the earliest date on which contributions can reasonably be segregated from the employer’s general assets. Plans are required to report all participant contributions that were not transmitted to the plan in accordance with the time period required by DOL Reg. 2510.3-102 on line 4a to Schedule H or I of Form 5500.

Determining when a contribution can be reasonably segregated is a matter of professional judgment. An AICPA Technical Practice Aid at TIS 6932.02 provides guidance on considering whether remittances are delinquent. According to the practice aid, auditors should gain an understanding of the employer’s process for remitting employee contributions. Determining when an employer is able to reasonably segregate employee contributions from its general assets depends on the facts and circumstances surrounding the plan. For instance, employers with complex corporate structures and payroll processes may require more time to segregate and remit employee contributions than other employers with simpler structures and processes. Therefore, determining what is reasonable will vary from plan to plan. Auditors should also consider whether the employer has experienced any changes that may impact the process of segregating and remitting employee contributions (such as a change in payroll processing or the hiring of a new service provider). If the auditor encounters any instances during the plan year in which the employer has deviated from its established process for remitting employee contributions, the auditor should obtain a further understanding of that deviation and consider whether it resulted in a violation of DOL regulations. Plan sponsors may wish to consult with legal counsel if they have questions regarding application of this DOL regulation.

Considering the emphasis by the EBSA regarding this issue, the auditor should consider applying the following procedures in addition to those discussed previously to address the possibility of untimely remittance of participant contributions:

- Determine whether the plan is eligible for the safe harbor for the transfer of participant contributions and has elected to comply with that provision.

- Make inquiries of plan management regarding whether participant contributions are remitted to the plan on a timely basis as required by the DOL regulations and whether plan management has policies and procedures in place to ensure the timely remittance of contributions.

- Request that plan management prepare a schedule of participant contributions for the year under audit. The schedule should include the date contributions were either withheld or received by the employer and the date the contributions were remitted to the plan. The auditor should then test the schedule for completeness and accuracy. The auditor should also review the listing of contributions and inquire about any contribution(s) that appear(s) to be in violation of DOL regulations.

- If late remittances are discovered, either through inquiry of plan management or the analysis of participant contributions for the year, the auditor should consider performing additional procedures to ensure all instances of late remittances are properly identified. Additional procedures may include requesting that the plan sponsor analyze all payroll remittances for the period to identify other late remittances. The auditor should review the results of the sponsor’s additional analysis and consider further testing as necessary. The auditor should also consider whether late remittances are properly reported on the plan’s Form 5500.
Withdrawals, Terminations, and Forfeitures. Withdrawals (including hardship withdrawals, terminations, and forfeitures) may be tested by tracing terminated or withdrawing participants to and from the employer’s payroll records and the plan’s termination or withdrawal records. Support such as termination notices and withdrawal requests may be examined. Income tax withholding may also be tested. The withdrawal or forfeiture amounts for individual participants may be recalculated. Payments for withdrawals may be traced to cash disbursements records and to information on annuity purchases tested in the audit of insurance contracts. The disposition of forfeitures should be traced to the record of forfeited amounts and either reallocated to remaining participants or returned to the plan sponsor in accordance with plan provisions, board resolutions of the plan sponsor, and authorizations of the plan’s trustees or administrative or investment committee.

Additional Procedures for Defined Benefit Retirement and Health and Welfare Plan Participant Data

If the plan is a defined benefit plan for which an actuarial determination of benefit obligations is obtained, the information tested should be traced to the participant data given to the plan actuary. Information about selected participants should also be traced from the actuary’s report or from a confirmation letter from the actuary to the employer’s personnel records.

Additional Procedures for Cash Balance Plans. A cash balance plan is a type of defined benefit plan in which the employer promises to pay a set benefit when the participant retires and because the benefits it provides are not related to the investment experience of the plan’s fund. However, unlike a typical defined benefit plan, a cash balance plan maintains a hypothetical account for each participant, which is credited with a contribution credit based on a prescribed employer contribution rate, and an interest credit as specified in the plan. When the participant retires, the benefit to be paid is the balance of the participant’s hypothetical account. An advantage of a cash balance plan over a traditional defined benefit plan is the visibility of the benefit provided each year because the benefit is expressed as a “cash account.” Under a traditional defined benefit plan, the employees see only what they have accrued as a future pension benefit and a current value is not placed on the accrued benefit. If the plan is a cash balance plan, the auditor may perform additional procedures relative to the participants’ hypothetical accounts. The auditor may obtain an understanding of the plan’s provisions for crediting participant accounts, including the interest rate used in the current year and how contribution credits are determined. If the contribution credit is based on participant earnings, the auditor may select a sample of participants and test the earnings used to determine their contribution credit. The auditor may also ensure any factor used for the contribution credit and the interest rate used in the current year’s interest credit comply with the provisions of the plan.

Additional Procedures for Defined Contribution Plan Participant Data

The employer contribution to a defined contribution plan may be based on individual participant data such as salary in a 401(k) plan and some health and welfare benefit plans. The auditor may test such an employer contribution by obtaining a schedule of the employer contribution by participant, checking its clerical accuracy, recomputing the employer contribution for participants selected in the test of payroll data based on the contribution rate specified in the plan and the relevant participant data, and relating the total contribution for all participants to the total employer contribution income recorded by the plan.

If the plan provides for participant-directed investment programs, the auditor should also determine that the employer’s contribution was allocated to the investment option(s) selected by individual participants. Many third-party service providers now maintain enrollment and allocation forms, or allow participants to enroll or change their investment allocations or contribution amounts electronically, such as by telephone, the Internet or an Intranet. These services leave the plan sponsor no documentation of the enrollment or changes. In such instances, the auditor may choose to obtain and read a service auditor’s SAS 70 report for the service provider. If a service auditor’s SAS 70 report is not available, the auditor may consider requesting copies of the enrollment or fund election forms from the service provider, if available. If the enrollment or allocation changes are made electronically, the auditor should consider confirming the information directly with the participant or performing appropriate procedures to test internal controls at the service provider’s location.

When testing participant data and employer and employee contributions for selected individuals, the auditor should determine that ERISA’s annual contribution limits to a defined contribution retirement plan are not exceeded. ERISA limits the annual amount of an employee’s elective deferral, and it limits the total annual contribution from the employer, employee, and forfeitures to the lesser of 100% of the employee’s compensation or
$49,000 for 2010 and $49,000 for 2009. Also, when testing hardship withdrawals from a 401(k) arrangement, the auditor should give consideration to, and examine support for, adherence to requirements including indication of the financial need for the hardship withdrawal, that only the participant’s elective deferral was withdrawn (and not any plan earnings), income tax withholding, and, if applicable, that the participant made no voluntary contributions or elective deferrals during the six months following the withdrawal.

Individual participant account balances do not appear in the plan financial statements. However, AEBP, Paragraph 10.20, indicates a list of procedures the auditor may apply to individual participant accounts (rather than at the plan level). Thus, the auditor may test the allocation of employer and participant contributions, plan income, gains and losses, administrative expenses, and forfeitures to individual accounts, agree or reconcile the sum of individual account balances to the net assets available for benefits and review the account balances for reasonableness. The auditor may be able to rely on a service auditor’s SAS No. 70 report of the plan’s recordkeeper, if one is available and it addresses participant allocations, to reduce the amount of substantive testing necessary when testing allocations to participant accounts. These procedures should be performed even if a DOL limited-scope is applied. The auditor may also determine that all plan participants have an individual account balance, that is, that the number of account balances agrees with, or reconciles to, the number of participants.

Many defined contribution plans allow participants to execute transactions on a daily or weekly basis. If the plan assets are publicly traded and valued daily, such as many mutual funds, the recording and testing of the daily valuations used in the transactions is fairly straightforward. However, if the plan assets include hard to value investments, such as limited partnerships, the auditor should determine how the assets are valued and the frequency of the valuations when testing participant transactions. If the assets are incorrectly valued, the participant’s account could be misstated, resulting in potential DOL penalties.

**Additional Procedures for Multiemployer Plans**

The auditor may not be able to examine participant records for a multiemployer plan in order to apply the basic auditing procedures described above. AEBP, Paragraph 10.06, states that in such a case, one or more of the following procedures may provide necessary assurance about participant data:

a. If the participant data on which contributions and/or actuarially determined amounts are based is maintained by the plan administrator, the data can be verified by direct confirmation with the participant, or by comparison with duplicate participant data records maintained by the union, if available.

b. If periodic visits to employers are made by a representative of the plan to test participant and other related data, these procedures may be reviewed for thoroughness and tested.

c. When available, agreed-upon procedures reports may be obtained from the employer’s auditor describing the procedures applied to the participant data and the findings. Those procedures should usually include tests to determine that all appropriate employees and payments are properly reported to the plan. The plan auditor may also instruct the employer’s auditor to apply additional procedures the plan auditor considers necessary in the circumstances. (Involvement by the plan auditor in the initial planning for the agreed-upon procedures will usually negate the need for additional procedures and ensure that the agreed-upon procedures meet the needs of the auditor.)

d. The plan auditor may engage other auditors to test participant data. In these instances, the plan auditor normally provides the other auditor with a program detailing the procedures to be performed, the number of selections to be tested, materiality (when applicable), and other necessary information to complete the tests. (If complete information is maintained by the plan administrator, the plan auditor may select the items to be tested and forward the selections to the other auditor.) In these instances, the other auditor generally provides the plan auditor with the workpapers and no report is issued.

There are also other procedures the auditor may consider performing for multiemployer plans, including:

a. Comparing the employers’ contribution reports to the participants’ earnings records.

b. Reviewing the employee information in the participants’ records to verify that participants were properly included in or excluded from the employers’ contribution reports.
c. If the plan administrator does not keep participant information, inquiring about the procedures used to obtain the data and determining the adequacy of those procedures.

Procedures Performed by Other Auditors. The plan auditor should determine early in the planning process if other auditors will be needed to perform certain audit procedures at participating employer’s locations. An interpretation of AU 543 (AU 9543.01-.03) indicates that the principal auditor is responsible for determining the extent of procedures for the other auditor to perform. The interpretation also requires the other auditor to report the results of the procedures “solely for the use of the principal auditor” which allows greater flexibility for the other auditor in reporting the results of procedures requested by the principal auditor.

The plan auditor may be able to work with the plan administrator and develop a rotation plan to avoid performing certain audit tests at each participating employer every year. Several factors affect the decision, including the number of employers involved in the plan, the number of participants at each location, whether the plan periodically visits employers to test data, and the prior year results. In a rotation plan, testing is performed only at selected locations each year, with every location being tested at least once every two or more years. While some plans may by design require such audits more often than the auditor considers necessary, the auditor should use his or her judgment to determine whether a rotation plan meets the minimum audit requirement. The rotation plan, if implemented, should be documented or updated during planning.
SELF-STUDY QUIZ

23. Which of the following is the most important reason for auditing participant data?
   a. It is a basic audit requirement.
   b. It is used to determine material amounts in the financial statements.
   c. It is a requirement of most companies.
   d. It makes an IRS audit less likely.

24. Participant data is used for all of the following reasons except:
   a. Determining material amounts in financial statements.
   b. Accruing benefits in a defined benefit retirement plan.
   d. Determining individual participant account balances in defined contribution plans.

25. If the plan document includes a provision for either voluntary or mandatory employee contributions, by which of the following could the auditor determine the basis for the employee contribution?
   a. The employee’s contribution history.
   b. Company recommendations.
   c. The employee’s authorization.
   d. Contribution patterns of similar companies.

26. The defining characteristic in determining the timeliness of the employer’s remittance of participant contributions to a defined contribution plan is:
   a. If remittance of contributions is made within 15 days after being withheld.
   b. If remittance of contributions is made within 90 days after being withheld.
   c. The earliest date contributions can reasonably be segregated from the employer’s general assets.

27. The auditor should perform additional procedures relative to the participants’ hypothetical accounts for which of the following plans?
   a. Defined benefit plans.
   b. Cash balance plans.
   c. Defined contribution plans.
28. Emily is auditing the defined contribution plan participant data for Glass House Fixtures. The plan allows individuals to have participant-directed investments and the participants can make these elections on the plan’s website. Emily is trying to verify participant’s elections. What is the best auditing procedure for Emily to accomplish her goal?

a. Emily should obtain a copy of the employer contribution schedule and check it for clerical accuracy.

b. Emily could trace the deduction from the employee’s paycheck to the employee’s account within the plan.

c. Emily could request a SAS 70 report for the service provider.

d. Substantiate the election information directly with the participant.
SELF-STUDY ANSWERS

23. Which of the following is the most important reason for auditing participant data? (Page 192)

   a. It is a basic audit requirement. [This answer is incorrect. Auditing participant data is not a basic audit requirement, but is advisable.]

   b. It is used to determine material amounts in the financial statements. [This answer is correct. Participant data is used in determining material amounts presented in the financial statements, therefore, auditing such data is important in ensuring accuracy.]

   c. It is a requirement of most companies. [This answer is incorrect. Whether a company requires that participant data be audited is not the most important reason for doing so.]

   d. It makes an IRS audit less likely. [This answer is incorrect. Whether a company has audited participant data is not a factor used by the IRS when making an audit decision.]

24. Participant data is used for all of the following reasons except: (Page 192)

   a. Determining material amounts in financial statements. [This answer is incorrect. Participant data is used for determining material amounts in financial statements and includes information such as salary, service years, and hours worked in the current period.]

   b. Accruing benefits in a defined benefit retirement plan. [This answer is incorrect. Participant data is used in accruing benefits in a defined benefit retirement plan such as when a defined benefit plan provides for benefit accruals as a specified percentage of a participant’s salary for each year of employment.]

   c. Determining Social Security benefits. [This answer is correct. Participant data is not used to determine Social Security benefits. It is used, however, in determining health and welfare benefits. For example, the hire date may affect vacation accruals.]

   d. Determining individual participant account balances in defined contribution plans. [This answer is incorrect. Participant data is used in determining the individual participant account balances that ERISA requires contribution plans to maintain. These account balances can be used to allocate total plan contributions, income and losses, and forfeitures to individual participants and also to record activity by individual participants.]

25. If the plan document includes a provision for either voluntary or mandatory employee contributions, by which of the following could the auditor determine the basis for the employee contribution? (Page 193)

   a. The employee’s contribution history. [This answer is incorrect. The employee’s contribution history is not a basis for determining the employee’s contribution. The employee may choose to increase or decrease his or her contribution from that of previous years.]

   b. Company recommendations. [This answer is incorrect. The basis for employee contribution is not based on or determined by company recommendations. The company may have mandatory contributions that are required, but it does not make recommendations to the employee for voluntary contributions. That decision is left to the employee based on the employee’s specific needs or goals.]

   c. The employee’s authorization. [This answer is correct. An auditor can determine the basis for the employee contribution by using the employee’s authorization, the plan document, or the collective bargaining agreement.]

   d. Contribution patterns of similar companies. [This answer is incorrect. The basis for the employee contribution is not determined by what other company’s policies are regarding contributions.]
26. The defining characteristic in determining the timeliness of the employer’s remittance of participant contributions to a defined contribution plan is: (Page 194)

a. If remittance of contributions is made within 15 days after being withheld. [This answer is incorrect. DOL officials have indicated that the 15 day maximum period for remittance is not a safe harbor.]

b. If remittance of contributions is made within 90 days after being withheld. [This answer is incorrect. The 90 day maximum period for remittance is not considered a safe harbor by DOL officials.]

c. The earliest date contributions can reasonably be segregated from the employer’s general assets. [This answer is correct. The earliest date on which contributions can reasonably be segregated from the employer’s general assets is the defining characteristic in determining whether contributions to the plan are considered to be in compliance with the regulations. EBSA officials suggested auditors compare the timeliness of the employer’s remittance of participant contributions to the plan to the timeliness of the employer’s remittance of FICA and FIT withholdings to appropriate sources.]

27. The auditor should perform additional procedures relative to the participants’ hypothetical accounts for which of the following plans? (Page 195)

a. Defined benefit plans. [This answer is incorrect. The employer promises to pay a set benefit when the participant retires. The benefits it provides are not related to the investment experience of the plan’s fund nor a hypothetical account.]

b. Cash balance plans. [This answer is correct. For cash balance plans, the auditor may perform additional procedures relative to the participants’ hypothetical accounts. A hypothetical account is maintained by a cash balance plan for each participant which is credited with a contribution credit based on a specific employer contribution rate and an interest credit as specified in the plan.]

c. Defined contribution plans. [This answer is incorrect. Actual participant accounts are maintained for defined contributions plans. They are not hypothetical accounts.]

28. Emily is auditing the defined contribution plan participant data for Glass House Fixtures. The plan allows individuals to have participant-directed investments and the participants can make these elections on the plan’s website. Emily is trying to verify participant’s elections. What is the best auditing procedure for Emily to accomplish her goal? (Page 195)

a. Emily should obtain a copy of the employer contribution schedule and check it for clerical accuracy. [This answer is incorrect. This procedure would confirm that employer contributions had been calculated correctly, when the contribution is based on a set arrangement or percentage, but it would not validate a participant’s elections for Emily.]

b. Emily could trace the deduction from the employee’s paycheck to the employee’s account within the plan. [This answer is incorrect. This procedure would verify that deductions taken out of an employee’s paycheck were allocated to their benefit plan, but it would not tell Emily the election that the employee designated on the plan’s website.]

c. Emily could request a SAS 70 report for the service provider. [This answer is incorrect. While a SAS 70 report would provide Emily with a description of the degree to which the service organization fairly represents its services in regards to internal controls that have been implemented in operations and its inherent design to achieve objectives set forth, it would not provide specific information on participant’s elections, so Emily would not be able to validate the participant’s elections.]

d. Substantiate the election information directly with the participant. [This answer is correct. If the plan allows participants to enroll or change their investment allocations electronically, such as by telephone, the Internet or an Intranet, this leaves the plan sponsor with no documentation of the enrollment or changes. If so, the auditor should consider confirming the information directly with the participant, so that the participant can corroborate that the information they entered on the website is the information that is currently in the plan for the participant.]
EXAMINATION FOR CPE CREDIT
Lesson 1 (EBPTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following provides audit guidance relevant to audits of employee benefit plans?
   a. SAS No. 61.
   b. SAS No. 62.
   c. SAS No. 73.
   d. SAS No. 87.

2. If ERISA requires sponsors of single-employer defined benefit retirement plans to fund the annual contribution in quarterly installments, funding of those installments must be made by which of the following methods?
   a. The first three quarterly installments can be as little as 10% of the required annual payment, with the final installment making up the balance of the required annual payment.
   b. The first three quarterly installments can be as little as 15% of the required annual payment, with the final installment making up the balance of the required annual payment.
   c. The first three quarterly installments must be at least 20% of the required annual payment, with the final installment making up the balance of the required annual payment.
   d. Each installment must be at least 25% of the required annual payment. If the required annual payment is fulfilled after two or three installments have been made, no further payment is required.

3. The fair value at the date of contribution should be reviewed for any ________________.
   a. Rollover contributions.
   b. Noncash contributions.
   c. Defined contribution plan contributions.
   d. Multiemployer plan contributions.

4. Employer contributions are generally self-assessed by the participating employer based on uniform contribution rates and how many hours or days are worked, or the number of employees for which of the following plan contributions?
   a. Rollover contributions.
   b. Defined benefit plan contributions.
   c. Defined contribution plan contributions.
   d. Multiemployer plan contributions.
5. Which of the following would **not** meet the necessary criteria for an employee benefit plan to record a contribution receivable for amounts due from the employer?

   a. Approval of a specified contribution by means of a resolution issued by the employer’s governing body.
   
   b. A consistent pattern of payments being made after the plan’s year end under an established funding policy that indicates such payments were applied to the preceding plan year.
   
   c. Recognizing a receivable solely because the employer has recorded a contribution payable to the plan.
   
   d. The employer’s deduction on its federal income tax return of a contribution for periods ending on or before the reporting date.

6. If an employer partially or completely withdraws from a multiemployer plan, they must continue to fund a proportional share of the plan’s unfunded vested benefits. The withdrawal liability is payable over what period of time?

   a. 20 years.
   
   b. 15 years.
   
   c. 10 years.
   
   d. 7 years.

7. An auditor can usually obtain adequate audit evidence about investments by applying procedures to the plan’s investment records with which of the following types of trusts?

   a. Discretionary trusts.
   
   b. Nondiscretionary trusts.
   
   c. Collective trusts.
   
   d. Master trusts.

8. The auditor may need to obtain a service auditor’s SAS 70 report or apply procedures at the trustee’s location for investments held in which type of trust?

   a. Master trust.
   
   b. Collective trust.
   
   c. Nondiscretionary trust.
   
   d. Discretionary trust.

9. The auditor should audit investment activity by examining an analysis of the change in the investments during:

   a. The three months prior to the period under audit.
   
   b. The four months prior to the period under audit.
   
   c. The six months prior to the period under audit.
   
   d. The period under audit.
10. If the plan engaged a specialist to value the investments, or if the auditor deems a specialist necessary to assist
the auditing of the plan’s valuation, the auditor should follow the requirements of which of the following?

   a. SAS No. 70.
   b. SAS No. 72.
   c. SAS No. 73.
   d. SAS No. 101.

11. Which of the following is accomplished by the direction found in SAS No. 101?

   a. Provides guidance on disclosures in financial statements.
   b. Addresses specific types of assets.
   c. Addresses industry-specific practices.
   d. Amends certain specified SASs.

12. In order to be considered reasonable, plan management assumptions need to be realistic and consistent with
all of the following except:

   a. Information from the market.
   b. Assumptions from past periods, if appropriate.
   c. Industry standards.
   d. Prior results of the plan, as applicable.

13. Karen is planning on using a SAS 70 report as evidential matter to verify that the trustee of the employee benefit
plan of Brownstone, Ltd. has the authority to initiate investment transactions. Use of the SAS 70 report is an
example of what type of auditing procedure?

   a. Analytical procedures.
   b. Substantive procedures.
   c. Sampling.
   d. Confirmations.

14. Nancy has been engaged to audit the investments of a plan that makes the best use of its resources by pooling
the assets of three unrelated plans at a bank. The bank holds the investments in trust for the participating plans.
What type of investments is Nancy auditing?

   a. Investments in omnibus accounts.
   b. Investments held in a discretionary trust.
   c. Investments in a master trust.
   d. Investments in common/collective trust.
15. First Bank, the trustee for Company D’s 401(k) plan, allows participants to change their investment allocations via telephone or Internet. What additional procedures should the auditor consider performing related to investments?
   a. Obtain the service auditor’s SAS 70 report on internal controls relevant to participant data.
   b. Examine evidence of ownership, such as stock certificates.
   c. Analyze the change in the investments during the period under audit.
   d. Confirm investment allocation changes with the participant.

16. Gavin has been engaged to audit the investments in a employee benefit plan. After reviewing the investments, Gavin has determined that the investments are in an omnibus account. Which characteristic of the investments enabled Gavin to identify it as an omnibus account?
   a. The investments are held at a financial institution, but held in a trust, with the bank having no ownership of the assets.
   b. Numerous benefit plans are combined for the advantageous trading options.
   c. A trustee is specified for the investments and has the right to initiate investment transactions.
   d. The benefit plan includes investments in real estate, mortgages and limited partnership interests.

17. Auditors that need special knowledge or skills to audit complex derivative instruments and hedging activities may elect to acquire that knowledge or skills from others within the auditor’s firm by following guidance in:
   a. SAS No. 108 or SAS No. 73.
   b. SAS No. 72 or SAS No. 73.
   c. SAS No. 73 or FASB ASC 815.
   d. FASB ASC 815 or SAS No. 22.

18. Which of the following is classified as an unallocated contract?
   a. Individual ordinary life insurance policy.
   b. Group permanent insurance contract.
   c. Synthetic guaranteed investment contract.
   d. Deferred group annuity contract.

19. Which of the following statements is inaccurate regarding determinations the auditor should make when auditing contracts?
   a. Whether the account is allocated or unallocated.
   b. Whether there are guaranteed interest rates or not.
   c. Whether a general account or separate (individual or pooled) account.
   d. Age of contract (determines whether to value at contract or fair value).
20. What type of procedures should an auditor apply in a DOL limited-scope audit to information on contracts that are retained as investment vehicles and that have been prepared and certified as being complete and accurate by the financial institution or insurance company?
   
   a. No procedures.
   b. Analytical procedures.
   c. Substantive procedures.
   d. Detailed procedures.

21. The auditor should review investment yield information made available to the plan by the insurance company to test the reasonableness of interest credited to which of the following?
   
   a. Deposit administration (DA) contracts.
   b. Immediate participation guarantee (IPG) contracts.
   c. Guaranteed investment contracts (GIC).
   d. Synthetic guaranteed investment contracts.

22. Although pooled separate accounts are held at insurance companies instead of financial institutions, the pooled separate accounts have the same characteristics as what other type of accounts?
   
   b. Discretionary trusts.
   c. Mutual funds.
   d. Master trusts.

23. Participant data includes all of the following except:
   
   a. Age.
   b. Sex.
   c. Educational background.
   d. Hire date.

24. If an auditor other than the plan auditor audits the plan sponsor, the plan auditor may be able to have the other auditor(s) apply agreed-upon procedures during the audit of the employer’s payroll costs and issue a report in accordance with which of the following?
   
   a. Guidance in AEBP.
   b. SSAE No. 10, as amended.
   c. SAS No. 92.
   d. ERISA requirements.
25. For most pension benefit plans, when should an employer remit any amounts withheld by an employer for remittance to a benefit plan for the repayment of a participant loan?
   a. By the 7th business day of the month following the month the amounts were withheld.
   b. By the 10th business day of the month following the month the amounts were withheld.
   c. By the 15th business day of the month following the month the amounts were withheld.
   d. By the 20th business day of the month following the month the amounts were withheld.

26. Company A normally remits participant contributions to its plan on the fifth business day after the end of the pay period. Which of the following could be considered a prohibited transaction for Company A?
   d. Pay period ended November 1, 2009; participant contributions remitted November 8, 2009.

27. Which of the following statements accurately describes the process of determining when a contribution can be reasonably segregated?
   a. The determination is made based on a formula used as the industry standard.
   b. The determination is made based on precedent.
   c. The determination is made based on GAAP.
   d. The determination is a matter of professional judgment.

28. Stephen is auditing the employee benefit plan of White Cap Industries. He has been assigned to examine employee terminations. Which of the following is an audit procedure that Stephen would use?
   a. Test the earnings of an employee and determine their contribution.
   b. Confirm the employee contribution off the paycheck to the contribution to the plan by the employer.
   c. Trace participants from the employer’s payroll records to the plan’s withdrawal records.
   d. Review plan documents and determine eligibility requirements for participants.
Lesson 2: Benefit Payments, Benefit Obligations, Other Assets, Liabilities, and Operating Expenses, and Change in Service Organizations

INTRODUCTION

This lesson discusses specific audit considerations and procedures related to things such as audit procedures for testing benefit payments, how to calculate and test benefit obligations, other assets, liabilities, and operating expenses, as well as how to select appropriate analytical procedures and identify required procedures for a change in service organizations.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify audit procedures for testing benefit payments.
- Describe how benefit obligations are calculated and tested.
- Summarize audit procedures for other assets, liabilities, and operating expenses.
- Recognize appropriate analytical procedures and identify required procedures for a change in service organizations.

BENEFIT PAYMENTS

Benefit payments may be paid directly from plan assets or by the purchase of annuity contracts with insurance companies. The actual payments may be made by the bank or insurance company that holds the plan assets, upon the plan administrator’s authorization. For defined contribution retirement plans, benefit payments include withdrawals of employee voluntary after-tax contributions and payments of individual participants’ account balances to terminating employees. All these types of payments are reported as deductions in the statement of changes in net assets available for benefits.

Disbursements for benefit payments should be distinguished from loans to participants. Employee benefit plans that have individual participant accounts are allowed to provide for loans to participants if, among other things, the loan is adequately secured. To meet this requirement, a plan may limit the amount of the loan to a percentage of a participant’s vested account balance. Loans to plan participants are reported as plan assets (loans receivable) in the statement of net assets available for benefits rather than as deductions in the statement of changes in net assets available for benefits.

Audit Procedures

Audit procedures for benefit payments start with obtaining a schedule of benefit payments and tracing its totals to the plan’s general ledger or trial balance and reports of trustees who made the payments. Analytical procedures can be applied such as considering the reasonableness of current and prior-year payment amounts in relation to the number of people who received payments and investigating any unusual fluctuations.

The primary audit procedures for benefit payments involve testing payments to selected recipients for eligibility and accuracy of method and amount of payment. Sampling in such tests is moderately likely, depending on the volume of payments. According to AEBP, Paragraph 12.20, when auditing a terminating plan, auditors may consider performing additional benefit payment testing during the period the termination benefits are paid because of the significance of the payments.

For selected payments, the auditor examines approvals and supporting documents, such as an approved benefit election form for a retiring participant, a withdrawal request or employment termination notice, a statement from a health provider like a doctor’s bill, or a death certificate supporting a death benefit paid. The auditor tests the participant’s eligibility to receive the benefit under the plan’s provisions by examining evidence of age, years or
hours of service, etc. He recomputes the benefit amount based on the participant’s eligibility and plan provisions and traces the payment to cash disbursements or the trustee’s report of payments. For defined contribution retirement plans, the amount should also be traced to the individual participant’s account. The auditor may also trace amounts from trustee reports to the plan’s records and supporting documents. The auditor may also test receipt of benefit payments by examining supporting documents, such as canceled checks, or by confirming payments directly with participants or beneficiaries. When applicable, signatures on cancelled checks, etc., may be compared to cash disbursement or other records.

**Termination of Benefit Payments.** An important auditing consideration is the plan’s procedures for stopping payments at the appropriate time, for example, at the recipient’s death. An audit procedure that may disclose that payments are being made to deceased persons is comparison of the signature on canceled checks with that on the application for benefits. Also, the auditor can investigate long-outstanding checks for possible indication that the intended recipient has died. Finally, the auditor should check that when death benefit payments are made, the deceased’s name is removed from the benefit rolls. The auditor may also consider confirming payments with participants or their beneficiaries, depending on the result of these procedures.

**Service Organizations.** If an outside service organization such as a bank, insurance company, or third-party administrator determines or makes benefit distributions, the plan auditor may have to obtain a service auditor’s SAS 70 report on the organization’s controls or apply auditing procedures at the service organization. The auditor should also consider testing the accuracy of the claims eligibility data used by the claims administrator to pay or reject claims. Since a DOL limited-scope audit only limits the scope relative to investments and related transactions (and not benefits paid), this procedure would apply even in a limited-scope audit.

**ERISA and Tax Requirements**

The auditor should keep in mind relevant ERISA and tax requirements that should be tested when testing benefit payments. For example, IRC Section 401(a)(11) requires retirement plans that provide benefits in the form of an annuity to provide a joint and survivor annuity unless the participant, with spousal consent, elects otherwise. Also, a qualified domestic relations order (QDRO) may be issued by a state court as part of a divorce settlement specifying that a former spouse is to receive all or part of the participant’s benefits payable. In such a case, the former spouse must consent to waiving the joint and survivor benefit form of payment. The auditor should check for compliance with these requirements and examine consent forms when examining benefit election documents. Income tax withholding should also be tested. Finally, the maximum benefit paid from a qualified defined benefit plan should not exceed the IRC limit.

**Locating Missing Participants.** The auditor should also be aware of the plan administrator’s fiduciary duty to locate missing participants or beneficiaries so that applicable benefit payments may be made. Title 1 of ERISA does not provide specific procedures fiduciaries must follow to locate missing participants, but the fiduciary must use reasonable efforts to locate the participant such as sending a letter to the last known address. In addition, the plan may contact one or more government agencies, such as the Social Security Administration, the IRS, and the PBGC, for assistance in locating the missing participant. If the auditor notices payments not being made because of missing participants or if this risk was identified during the risk assessment process, he or she should inquire about the efforts made to locate them. EBSA Field Assistance Bulletin (FAB) 2004-02 provides guidance to plan fiduciaries related to locating missing participants in terminated defined contribution plans subject to ERISA. FAB 2004-02 is available on the EBSA website at [http://www.dol.gov/ebsa/regs/fab_2004-2.html](http://www.dol.gov/ebsa/regs/fab_2004-2.html). Additional guidance on procedures for locating missing participants is included in PPC’s Guide to Small Employer Retirement Plans, which may be ordered by calling Thomson Reuters at (800) 431-9025 or by accessing [ppc.thomsonreuters.com](http://www.dol.gov/ebsa/regs/fab_2004-2.html).

**Rollover Distributions**

Rollover distributions are transfers from a qualified plan to another qualified plan or to an individual retirement account. If the plan allows for rollovers, the auditor should verify that the rollover was made according to the provisions of the plan, and the rollover account is in the participant’s or beneficiary’s name. Generally, distributions from a qualified retirement plan may be rolled over to any other tax-favored retirement plan, such as a Section 403(b) annuity plan. Further, after-tax contributions can be included in an eligible rollover distribution to a qualified plan or an IRA.
SELF-STUDY QUIZ

29. Benefit payments are characterized by which of the following?
   a. Disbursements for benefit payments do not need to be separated from loans to participants.
   b. Benefit payments may be paid directly from plan assets.
   c. Actual benefit payments must be made by the plan administrator.
   d. For defined contribution retirement plans, payments are not reported as deductions in the statement of changes in net assets available for benefits.

30. For a defined contribution plan, the auditor can validate the participant’s eligibility for benefit payments under the plan’s provisions using evidence of several factors including:
   a. Participant’s salary.
   b. Date of participant’s most recent promotion.
   c. Participant’s number of dependents.
   d. Participant’s age.
SELF-STUDY ANSWERS

29. Benefit payments are characterized by which of the following? (Page 209)

   a. Disbursements for benefit payments do not need to be separated from loans to participants. [This answer is incorrect. Disbursements for benefit payments should be distinguished from loans to participants since loans are repaid by the participant to the plan.]

   b. Benefit payments may be paid directly from plan assets. [This answer is correct. Benefit payments may be paid directly from plan assets or they may be paid by the purchase of annuity contracts with insurance companies.]

   c. Actual benefit payments must be made by the plan administrator. [This answer is incorrect. Actual benefit payments may be made by the insurance company or the bank that holds the plan assets with authorization by the plan administrator.]

   d. For defined contribution retirement plans, payments are not reported as deductions in the statement of changes in net assets available for benefits. [This answer is incorrect. For defined contribution retirement plans, all types of payments are reported as deductions in the statement of changes in net assets available for benefits.]

30. For a defined contribution plan, the auditor can validate the participant’s eligibility for benefit payments under the plan’s provisions using evidence of several factors including: (Page 209)

   a. Participant’s salary. [This answer is incorrect. A participant’s salary is not a factor in determining his or her eligibility for benefit payments from a defined contribution plan.]

   b. Date of participant’s most recent promotion. [This answer is incorrect. The date a participant received his or her most recent promotion is not relevant when determining eligibility for benefit payments.]

   c. Participant’s number of dependents. [This answer is incorrect. A participant’s number of dependents does not affect eligibility for benefit payments.]

   d. Participant’s age. [This answer is correct. A participant’s age would be a factor to consider when determining eligibility for benefit payments. If the participant has not reached 59 1/2 years of age, he or she will have to pay a penalty for early withdrawal.]
BENEFIT OBLIGATIONS

The actuarial present value of accumulated plan benefits is determined by first calculating accrued benefit obligations and then applying actuarial assumptions and methods to account for the time value of money and the probability of payment. The plan actuary usually computes both the accumulated plan benefits from participant census data supplied by the plan administrator and the actuarial present value of accumulated plan benefits.

Defined Benefit Retirement Plan Obligations

The main audit procedure for the actuarially determined plan obligations of a defined benefit retirement plan is to obtain a confirmation from the plan actuary. The actuary may provide a copy of his or her report as part of the response to the confirmation request. Or, the auditor may use a report provided by the actuary to the client and then determine that the information obtained from the client agrees with or reconciles to the information in the confirmation or report received directly from the actuary.

The auditor may determine the completeness of the census data the actuary used in his or her actuarial determination by reconciling the aggregate census data (number of participants and total compensation) from the employer’s records tested to the actuary’s report and confirmation.

The auditor may determine that only eligible employees are included in the census data by comparing the number of participants and the ratio of participants to total employees for the current and prior year and investigating any unusual fluctuations.

It is important to determine that the actuary used the appropriate plan provisions in making his or her actuarial determination. Thus, the auditor may compare the most recent applicable plan provisions and amendments to those the actuary used in his or her actuarial determination and summarized in the actuary’s report or confirmation.

The auditor should be aware that the plan may be operating in accordance with changes required by recent laws and regulations (and the actuarial valuation may reflect such changes), but that the plan may not have been formally amended for such changes. Thus, the auditor may not be able to just compare formal plan provisions and amendments, but may also have to consider any resolutions of the plan’s administrative board that affect the valuation.

After considering the completeness of census data and appropriateness of the plan provisions the actuary used in a defined benefit retirement plan actuarial determination, the auditor should consider whether the actuary’s assumptions and methods conform to FASB ASC 960 (formerly SFAS No. 35) and ERISA requirements and appear reasonable in relation to the plan’s provisions and experience.

For example, the auditor should consider whether the assumed rates of return on plan assets used in the actuarial determination are consistent with the plan’s investment policy and the types of investments the plan holds. Also, FASB ASC 960-20-35-1A (formerly SFAS No. 35, Paragraph 21), allows the selection of certain assumptions based on the assumptions inherent in the cost of an insurance contract at the benefit information date to provide the accumulated plan benefits. If a defined benefit retirement plan uses this approach to selecting assumptions for financial reporting purposes, the auditor should compare them to the insurance company premium rates the plan used.

The auditor should review the actuarial present value of accumulated plan benefits for reasonableness. For example, he or she may determine whether there are unusual fluctuations from the prior-year valuation and consider their causes, such as the effect of changes in actuarial assumptions and in circumstances like plant closings, etc. The auditor should carefully review the actuarial interest rate assumption for discounting benefit obligations. For example, a larger plan benefit obligation will result when the actuary uses a lower discount rate. Thus auditors should determine that the plan’s actuary has used a realistic interest rate in discounting the plan’s benefit obligations. FASB ASC 960-20-35-6 (formerly SFAS No. 35) requires that the interest rate assumption be based on the expected rates of return for the plan’s investment portfolio during the benefit deferral period.

The auditor may review the latest Schedule MB (“Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information”) or Schedule SB (“Single-Employer Defined Benefit Plan Actuarial Information”) to Form
5500 and review any qualifications the actuary has attached to the schedule. (The instructions to Form 5500 allow the actuary to qualify his or her statement.) The auditor should consider the audit or accounting significance of any qualifications.

Finally, the actuarial present value of accumulated plan benefits in the actuary’s report or confirmation should be traced, or reconciled, to the information in the plan’s financial statements.

**Benefit Obligations for Defined Benefit Health and Welfare Plans**

Health and welfare benefit plans may be insured or uninsured and an insurance company may assume all or part of the risk related to providing benefits of an insured plan. An uninsured, self-funded plan pays benefits out of a fund of accumulated contributions and income. A plan may be partly insured and partly self-funded. The financial statements of health and welfare benefit plans should include the actuarial present value of the following benefit obligations, as applicable:

a. Claims payable, claims incurred but not reported (IBNR) to the plan, and premiums payable to insurance companies.

b. Accumulated eligibility credits and postemployment benefits, net of current amounts payable, for active participants.

c. Postretirement benefits for—
   
   (1) Retired participants, their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR.
   
   (2) Other fully eligible plan participants.
   
   (3) Plan participants that are not fully eligible to receive benefits.

If claims IBNR are calculated for active participants and retirees in the aggregate, the total should be included with the amounts in a. above. However, claims IBNR for retirees should be included in the postretirement benefit obligation if it is calculated separately.

Note that the financial statements of self-insured (that is, uninsured) plans do not include obligations for premiums but do include obligations for claims payable for active and retired participants (and their dependents and beneficiaries), and the IBNR for active participants. The IBNR for retired participants is included in the postretirement benefit obligation. Insured plans report obligations for premiums and accumulated eligibility credits but do not report obligations for claims payable and claims IBNR because the insurance company pays such claims.

Because of the variety of insurance arrangements that a health and welfare benefit plan may have, it is important that the auditor read the plan document and underlying insurance contracts to determine the nature of the arrangement and the extent to which the insurance company assumes the obligation for plan benefits, and to identify the types of obligations for premiums, experience-rating adjustments, and plan benefits that should be reported in the plan’s financial statements.

The audit procedures will depend, in part, on whether a specific benefit obligation is determined by an actuary or by the plan. Postretirement benefits will generally be determined by an actuary. Insurance premium obligations (payables) will generally be determined by the plan. The remaining obligations may be determined by the plan or the actuary. However, GAAP requires that all amounts be at present value (that is, the value of time and money must be considered); that accumulated eligibility credits consider mortality, expected employee turnover, and other adjustments that may effect the actual amounts paid; and that postretirement and postemployment benefits be included.

GAAP requires disclosures of the actuarial present value of benefit obligations. The calculation of some of these obligations may require the assistance of an actuary. Health and welfare plans may consider not making these required disclosures because of the required involvement of an actuary. As an alternative, plans may make the
required disclosures based upon estimates developed by management of the plan. If the plan does not make the
required disclosures, or the disclosures are materially inadequate, the auditor generally should express a qualified
or adverse opinion due to the material departure from GAAP.

If the plan makes required benefit obligation disclosures based upon estimates made by plan management without
the use of an actuary, the auditor should consider the need to consult an actuary in evaluating the reasonableness
of the estimates. When the auditor decides to consult an actuary as a specialist, and the plan refuses to provide the
data necessary for the actuary to complete his or her work, the auditor’s opinion should be modified for a scope
limitation.

The main audit procedure for the actuarially determined benefit obligations of a defined benefit health and welfare
plan is to obtain a confirmation from the plan actuary. The actuary may provide a copy of his or her report as part
of the response to the confirmation request. Or, the auditor may use a report provided by the actuary to the client
and then determine that the information obtained from the client agrees with or reconciles to the information in the
confirmation or report received directly from the actuary.

The auditor may determine the completeness of the census data the actuary used in the actuarial determination, by
reconciling the number of participants from the employer’s records to the actuary’s report and/or confirmation and
by reconciling claims and accumulated eligibility credit information used by the actuary to the employer’s records.
The auditor should also determine that only eligible employees are included in the census data.

It is also important to determine that the actuary used the appropriate plan provisions in making the actuarial
determination. Thus, the auditor may compare the most recent applicable plan provisions and amendments to
those the actuary used in his or her report or confirmation. The auditor should be aware that the plan may be
operating in accordance with changes required by recent laws and regulations (and the actuarial valuation may
reflect such changes), but that the plan may not have been formally amended for such changes. Thus, the auditor
may not be able to just compare formal plan provisions and amendments, but may also have to consider any
resolutions of the plan’s administrative board that affect the valuation.

After considering the completeness of census data and appropriateness of the plan provisions the actuary used in
actuarial determinations, the auditor should consider whether the actuary’s actuarial assumptions and methods
conform to GAAP and ERISA requirements and appear reasonable in relation to the plan’s provisions and experi-
ence. For example, the auditor should consider whether the assumed rates of return on plan assets used in the
actuarial determination are consistent with the plan’s investment policy and the types of investments the plan holds.
Other actuarial assumptions the auditor should review for reasonableness and consistency with, if applicable, the
prior year’s actuarial determination include the current and ultimate health care cost trend rates and the salary
progression for pay-related plans.

The auditor should review the actuarial present value of benefit obligations for reasonableness. For example, the
auditor may determine whether there are unusual fluctuations from the prior-year valuation and consider their
causes, such as the effect of changes in actuarial assumptions and in circumstances like plant closings, etc. The
interest rate assumption used can greatly affect the calculation of the actuarial present value of benefit obligations.

The auditor may review the latest Schedule MB (“Multiemployer Defined Benefit Plan and Certain Money Purchase
Plan Actuarial Information”) or Schedule SB (“Single-Employer Defined Benefit Plan Actuarial Information”) to Form
5500 and review any qualifications the actuary has attached to the schedule. (The instructions to Form 5500 allow
the actuary to qualify his or her statement.) The auditor should consider the audit or accounting significance of any
qualifications.

Finally, the actuarial present value of benefit obligations in the actuary’s report or confirmation should be traced or
reconciled to the information in the plan’s financial statements.

**Auditing Insurance Premium Obligations.** The financial statements of insured health and welfare benefit plans
should report a benefit obligation for unpaid premiums payable to insurance companies. The amount of such
premiums is determined by participant eligibility and premium rates.

Audit tests for premiums payable include performing analytical procedures such as considering the reasonableness
of the current and prior-year premiums payable in relation to the number of participants and investigating
unusual fluctuations. The auditor may also make an overall calculation of premiums by multiplying the number of eligible participants (as determined from eligibility records) by the premium rate in the insurance contract. The auditor may decide to confirm premiums paid and payable with the insurance company. He or she may also examine support for the plan’s subsequent payment of the premium payable.

The auditor should determine that any experience-rated premium deficits or refunds that pertain to the plan year are properly recorded or disclosed.

**Auditing Unpaid Claims Reported to Uninsured Plans.** Uninsured plans do not have any obligations to insurance companies, but instead assume the obligation for unpaid claims incurred as of the financial statement date. The audit of these claims depends in part on whether an actuary is used to estimate the obligation. When an actuary is used, the procedures detailed above may be completed. When the plan estimates the obligation, the following procedures may be followed:

a. Obtain a trial balance of such claims and agree the total to the financial statements.

b. Review all or selected supporting documents (claims reports filed by participants prior to the financial statement date).

c. Trace subsequent payments of claims filed prior to the financial statement date to the trial balance.

**Auditing Claims Incurred but Not Reported (IBNR) to Uninsured Plans.** The obligation for claims incurred before the financial statement date but not reported to an uninsured plan at that date is estimated on an overall basis based on prior loss experience. The obligation should be determined based on the present value of the ultimate cost to settle the claims. When the plan estimates the obligation, the auditor should consider the estimate’s reasonableness and the estimation method’s consistency with the method used in prior periods. The auditor should also consider factors such as new circumstances, increasing claims costs, a changing trend of recent experience, catastrophic losses, plan amendments, etc.

FASB ASC 965-30-45-2 (formerly SOP 92-6) states that the estimated ultimate cost of IBNR claims should reflect the plan’s obligation to pay claims beyond the financial statement date. In practice, some plans may improperly be using a lag approach to record IBNR claims only for amounts reported subsequent to year-end but before the issuance of the financial statements. This method may not consider all future obligations to the plan relating to conditions that existed at the date of the financial statements. For example:

a. A plan participant who has a life-threatening accident in December may be unable to report all medical claims prior to the issuance of the December 31, 20XX financial statements. The IBNR obligation reflected in those financial statements should include the present value of the estimated ultimate cost to settle all future medical claims relating to the accident.

b. A plan participant who is diagnosed in December as having a very serious illness may be unable to report all medical claims relating to the illness prior to the issuance of the December 31, 20XX financial statements. The IBNR obligation reflected in those financial statements should include the present value of the estimated ultimate cost to settle all future medical claims relating to the illness.

c. A plan participant who is ill in December and is diagnosed in early January as having a very serious illness may be unable to report all medical claims relating to the illness prior to the issuance of the December 31, 20XX financial statements. Should the IBNR obligation reflected in those financial statements include the present value of the estimated ultimate cost to settle all future medical claims relating to the illness? The answer is not clear; however, it is believed the answer is yes.

The IBNR calculation is often complex. If an actuarial valuation is necessary, the auditor should discuss the need with the plan administrator at, or before, the beginning of the audit. When an actuary estimates the obligation, the procedures detailed above should be completed. The above procedures should also be applied to test the reasonableness of the estimates provided by the actuary.

**Auditing the Obligation for Accumulated Eligibility Credits.** Accumulated eligibility credits provide benefits coverage to eligible participants during periods of unemployment. An insured plan’s obligation is for the insurance
premiums related to the credits, and an uninsured plan’s obligation is for the benefits related to the credits. The obligation at the plan financial statement date is the number of credits times the current insurance premiums rate for insured plans or times the plan’s average benefits cost for uninsured plans, adjusted for the effect of assumptions for mortality, expected employee turnover, and other adjustments that may be necessary based on the provisions of the plan.

The audit of these claims depends in part on whether an actuary is used to estimate the obligation. When an actuary is used, the procedures detailed above should be completed. When the plan estimates the obligation, the following procedures may be considered:

a. Test the accuracy of the compilation of the number of credits by referring to participants’ credited service hours on a test basis and to the applicable accumulated rates in the plan.

b. Test the participant credited service hour records by referring, on a test basis, to payroll or similar type records.

c. Review the reasonableness of the mortality and other assumptions.

d. Check the computation.

The above procedures may also be appropriate to test census data provided to the actuary by the plan administrator.

**Auditing the Obligation for Postretirement Benefits.** Postretirement benefits consist of those benefits expected to be paid on behalf of retired or active participants, beneficiaries or covered dependents, and terminated participants who are expected to receive benefits under a health and welfare benefit plan. If a plan provides postretirement benefits, an estimated amount for those benefits should be included in the benefit obligations. An actuary will be required to determine the postretirement benefit obligation. In addition to performing the procedures noted above, the auditor may confirm the postretirement benefit obligation with the actuary. The auditor should review the actuarial assumptions used by the actuary for reasonableness and, if applicable, consistency with assumptions used in the prior year actuarial determination. The auditor should also verify that the postretirement benefit obligation is reduced by the actuarial present value of estimated future contributions of current plan participants. In addition, if the actuarial valuation date was other than the plan’s year end, the auditor should review the roll forward of the obligation for reasonableness and perform any tests considered necessary.

**Auditing the Obligation for Postemployment Benefits.** Postemployment benefit obligations are the benefits expected to be paid by health and welfare benefit plans to employees after employment but before retirement. GAAP requires that an estimate of that obligation be included in the plan’s benefit obligations. In addition to the procedures noted herein, the auditor may also perform the following:

a. Confirm the postemployment benefit obligation with the actuary.

b. Review the actuarial assumptions for reasonableness.

c. Verify that estimated future contributions of current plan participants are considered in the calculation.

d. Verify that an obligation was recognized if the event causing the obligation had occurred and the amount could be reasonably estimated.

e. Inquire if there were instances where an obligation was not recorded only because the amount could not be reasonably estimated.

**Liabilities for Benefits of Defined Contribution Health and Welfare Plans**

Little is said in FASB ASC 965 (formerly SOP 92-6) regarding the accounting for benefits of defined contribution health and welfare plans. However, it is believed the accounting should, to the extent applicable, be essentially the same as that for defined benefit plans except that claims filed, claims incurred but not reported, insurance premiums, and accumulated eligibility credits will be reported in the statements of net assets available for benefits, and changes in net assets available for benefits, as required in AEBS Chapter 4.
SELF-STUDY QUIZ

31. Defined benefit retirement plan obligations are correctly reflected by which of the following auditor actions?
   a. The completeness of the census data does not need to be confirmed.
   b. The auditor should confirm that all employees, both eligible and ineligible, are included in the census data.
   c. The actuary, not the auditor, is responsible for confirming that the appropriate plan provisions were used in making his or her actuarial determination.
   d. The auditor should be aware that the plan may not have been formally amended to reflect changes required by recent laws and regulations that the plan is operating in accordance with.

32. Health and welfare benefit plans can be described in which of the following ways?
   a. They may be uninsured.
   b. An insurance company must assume all risk related to providing benefits.
   c. Insured plans pay benefits out of a fund of accumulated contributions and income.
   d. Plans must be either fully insured or fully self-funded.

33. For defined benefit health and welfare plans, which of the following will generally be determined by an actuary?
   a. Insurance premium obligations.
   b. Postretirement benefits.
   c. Unemployment benefits.

34. When the plan estimates the obligation for claims incurred but not reported (IBNR) to uninsured plans, the auditor should consider the estimate’s reasonableness and the estimation method’s consistency with the method that was used in prior periods. The auditor should also consider all of the following factors except:
   a. New circumstances.
   b. Increasing claims costs.
   c. Losses of any magnitude.
   d. Plan amendments.
SELF-STUDY ANSWERS

31. Defined benefit retirement plan obligations are correctly reflected by which of the following auditor actions? (Page 213)

   (a) The completeness of the census data does not need to be confirmed. [This answer is incorrect. The auditor does need to confirm the completeness of the census data the actuary used in his or her actuarial determination by reconciling the aggregate census data from the employer’s records tested to the actuary’s report and confirmation.]

   (b) The auditor should confirm that all employees, both eligible and ineligible, are included in the census data. [This answer is incorrect. The auditor may confirm that only eligible employees are included in the census data by comparing the number of participants and the ratio of participants to the total number of employees for the current and prior year and scrutinizing any abnormal changes.]

   (c) The actuary, not the auditor, is responsible for confirming that the appropriate plan provisions were used in making his or her actuarial determination. [This answer is incorrect. The auditor may confirm that the actuary used the appropriate plan provisions when making his or her actuarial determination.]

   (d) The auditor should be aware that the plan may not have been formally amended to reflect changes required by recent laws and regulations that the plan is operating in accordance with. [This answer is correct. If the plan is operating in accordance with changes required by recent laws and regulations but it may not have been formally amended to reflect those changes, the auditor may not be able to compare formal plan provisions and amendments without considering any resolutions of the plan’s administrative board that affect the valuation.]

32. Health and welfare benefit plans can be described in which of the following ways? (Page 214)

   (a) They may be uninsured. [This answer is correct. Health and welfare benefit plans may be insured or uninsured. This is a characteristic of a health and welfare benefit plan.]

   (b) An insurance company must assume all risk related to providing benefits. [This answer is incorrect. An insurance company may assume part or all of the risk associated with providing benefits of an insured plan.]

   (c) Insured plans pay benefits out of a fund of accumulated contributions and income. [This answer is incorrect. An uninsured, self-funded plan pays benefits out of a fund of accumulated contributions and income.]

   (d) Plans must be either fully insured or fully self-funded. [This answer is incorrect. A plan may be partly insured and partly self-funded. This is a characteristic of a health and welfare benefit plan.]

33. For defined benefit health and welfare plans, which of the following will generally be determined by an actuary? (Page 214)

   (a) Insurance premium obligations. [This answer is incorrect. Insurance premium obligations will generally be determined by the plan.]

   (b) Postretirement benefits. [This answer is correct. Postretirement benefits will generally be determined by an actuary. GAAP requires that all amounts be at present value and that accumulated eligibility credits consider mortality, expected employee turnover, and other adjustments that may affect the actual amounts. This includes postretirement benefits, so they will need to be determined by an actuary.]

   (c) Unemployment benefits. [This answer is incorrect. Unemployment benefits are not determined by either an actuary or the plan.]
34. When the plan estimates the obligation for claims incurred but not reported (IBNR) to uninsured plans, the auditor should consider the estimate’s reasonableness and the estimation method’s consistency with the method that was used in prior periods. The auditor should also consider all of the following factors **except:**

*(Page 216)*

a. New circumstances. [This answer is incorrect. New circumstances **should** be considered by the auditor when the plan estimates the obligation for claims IBNR to uninsured plans since they could affect the estimate.]

b. Increasing claims costs. [This answer is incorrect. The auditor **should** take into account increasing claims costs when the plan estimates the obligation for claims IBNR to uninsured plans. Increasing claims cost will affect the obligation estimate.]

c. **Losses of any magnitude.** [This answer is correct. The auditor should consider **catastrophic losses,** as they are likely to effect the plan’s IBNR.]

d. Plan amendments. [This answer is incorrect. In addition to considering the estimate’s reasonableness and the estimation method’s consistency with the method that was used in prior periods, the auditor should also consider factors such as plan amendments and a changing trend of recent experience and now it will affect the plan in the future.]
OTHER ASSETS, LIABILITIES, AND OPERATING EXPENSES

Cash

Cash balances of an employee benefit plan are usually immaterial, representing residual uninvested amounts. AEBP, Paragraph 12.10, states that if cash balances are held in trust under a trust agreement or insurance contract, confirmation of the balance is normally adequate.

If the plan maintains cash accounts apart from any trust agreement or insurance contract, the same audit procedures applied in any audit are appropriate. That is, the balance may be confirmed, and procedures may be applied to the bank reconciliation using a cutoff statement if there are numerous or large reconciling items.

Rebates Receivable

If health and welfare plans have rebates receivable from a service provider, such as rebates from a prescription drug program or excess premiums paid for claims incurred, the audit procedures that may be applied include examining the rebates to determine if the correct amounts have been reflected in the proper periods. In addition, it is important for the auditor to gain an understanding of the service contracts and to apply procedures to determine if all rebates have been properly accounted for, and to consider the propriety of the rebates.

Operating Assets (Property and Equipment)

Employee benefit plans usually own or lease only immaterial amounts of property and equipment used in operations. Even large, single-employer plans may not have any such property. The plan sponsor often provides operating facilities and space (and may not charge the plan for the use of such facilities and space). Multiemployer plans, which are more likely to own or lease operating property and equipment, may not have material amounts. Also, plans that use third-party administrators may have little, if any, need for operating assets.

Material amounts of property and equipment used in plan operations would be audited in the same manner as in any audit.

The auditor should be aware that while FASB ASC 960-360-35-1 (formerly SFAS No. 35) and AEBP require plan operating property and equipment to be recorded at cost less accumulated depreciation and amortization, IRS Form 5500 requires buildings and other property used in operations to be presented at current value. The instructions to Schedule H, Financial Information, state that such property should be presented at “current (not book) value.” DOL officials have stated their expectation that current value will be used in the Form 5500 schedules and that the notes to the financial statements will disclose and reconcile the difference between the two amounts.

Property and equipment used in plan operations generally are carried in financial statements at cost less accumulated depreciation or amortization, unless an asset becomes impaired. The auditor should consider whether the asset is impaired and the carrying amount of the asset should be written down. FASB ASC 360-10-35-17 (formerly SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets), provides guidance on determining when long-lived assets are considered to be impaired and how to determine losses.

Accounts Payable (for Securities Purchased, Management Fees, and Operating Expenses)

A plan’s statement of net assets available for benefits may need to include a liability to brokers and dealers for securities purchased shortly before the financial statement date. Confirmations of investments may include a request for the amount of any payables as of the financial statement date. When testing investment transactions, the auditor should consider whether related payables have been recorded.

Loans Payable

Employee benefit plans may have debt. For example, a plan may have a mortgage on real property it owns. A leveraged ESOP borrows money from banks or other lenders to finance its acquisition of employer securities. Usually, the employer guarantees the debt. Tax rules provide that the employer’s stock is the only collateral that the
ESOP may use as collateral on the debt. The collateral stock must be placed in a suspense account and released for allocation to the ESOP participant accounts as the loan is repaid. Also, the ESOP may repay the loan only from employer contributions made to enable the ESOP to meet its loan obligation and from the earnings on those contributions.

The audit procedures for loans payable are the same as in any audit, that is, confirmation of the loan balance, terms, and collateral with the lender and tests of interest expense and accruals. A major audit objective is evaluation of the adequacy of disclosure of matters related to the loan, such as an employer’s guarantee of the debt or the restriction on the stock being used as collateral.

**Operating (Administrative) Expenses**

Operating expenses (also called administrative expenses) of an employee benefit plan may include items such as legal, actuarial, accounting, consulting, and data processing fees, investment trustee and advisory fees, fees to a third-party plan administrator, etc. Operating expenses may also include the PBGC insurance premium of a defined benefit retirement plan.

Many single-employer plan sponsors absorb part or all of the plan’s operating expenses. Such expenses are not reported in the plan’s statement of changes in net assets. However, FASB ASC 960-205-50-1 (formerly SFAS No. 35) and AEBP require financial statement disclosure of the fact that the plan sponsor is absorbing significant plan expenses, if applicable.

Audit procedures are similar to those for similar expenses in any audit. They include comparison of amounts with those of the prior period and investigation of significant fluctuations; examination of supporting invoices, contracts, and other documents; and overall analytical calculation of amounts based on the terms of agreements, leases, contracts, etc. In addition, the auditor may examine authorizations in the plan document or minutes of the administrative committee or board of trustees and consider whether expenses paid by the plan are permitted by the plan document. The AICPA Audit Risk Alert, Employee Benefit Plans Industry Developments—2009, states that auditors need to gain an understanding of the expenses that the plan document allows to be paid by the plan. If a plan pays expenses that are disallowed or that are excessive, without regard to materiality, additional testing may be required and such transactions may be deemed prohibited transactions.

When auditing the expense for GAAP financial statements, the auditor should determine that accruals and payables for operating expenses are properly recorded.
SELF-STUDY QUIZ

35. Which of the following requires buildings and other property used in operations to be presented at current value?
   a. FASB ASC 860.
   b. IRS Form 5500.
   c. AEBP.

36. Which of the following documents provides guidance on determining when long-lived assets are considered to be impaired and how to determine losses?
   a. SAS No. 92.
   b. SAS No. 101.
   c. FASB ASC 815.
   d. FASB ASC 360.
SELF-STUDY ANSWERS

35. Which of the following requires buildings and other property used in operations to be presented at current value? (Page 222)

   a. FASB ASC 960. [This answer is incorrect. FASB ASC 960 requires plan operating property and equipment to be recorded at cost less accumulated depreciation and amortization.]

   b. IRS Form 5500. [This answer is correct. IRS Form 5500, Schedule H, Financial Information, states that buildings and other property used in operations should be presented at current value, not book value.]

   c. AEBP. [This answer is incorrect. AEBP requires plan operating property and equipment to be recorded at cost less accumulated depreciation and amortization.]

36. Which of the following documents provides guidance on determining when long-lived assets are considered to be impaired and how to determine losses? (Page 222)

   a. SAS No. 92. [This answer is incorrect. SAS No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, provides guidance on auditing investments in debt and equity securities and investments accounted for under FASB ASC 323 (formerly APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock).]

   b. SAS No. 101. [This answer is incorrect. SAS No. 101, Auditing Fair Value Measurements and Disclosures, provides guidance on auditing fair value measurements and disclosures in financial statements.]

   c. FASB ASC 815. [This answer is incorrect. FASB ASC 815 (formerly SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities), as amended, provides disclosure requirements for derivative financial instruments and nonderivative instruments that are designated and qualify as hedging activities.]

   d. FASB ASC 360. [This answer is correct. FASB ASC 360 (formerly SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets), provides guidance on determining when long-lived assets are considered to be impaired and how to determine losses.]
OTHER AUDIT CONSIDERATIONS

Analytical Procedures

Many of the previous sections in this lesson address substantive analytical procedures that may be used to obtain audit evidence about potential misstatements. The following discussion expands on those procedures and provides further guidance for evaluating fluctuations and results from analytical procedures.

Selecting Appropriate Analytical Procedures. Analytical procedures include comparing actual results with industry statistics or anticipated results. However, auditors of employee benefit plans may not often make such comparisons because relevant information needed for a particular analytical procedure is either not available or not relevant to the plan. Instead, auditors generally use their experience with the plan and their knowledge of the relationships that are significant in the industry to determine which relationships should be studied. The following guidelines may be helpful in selecting appropriate analytical procedures:

a. To avoid applying unnecessary analytical procedures, determine the relationships that are significant to the plan. For example, the relationship of employer contributions to employer net income would not be significant to a plan where the employer contributions are based on a set amount for each hour worked.

b. Misstatements in an account can be distributed throughout the period or occur solely in one or a few months. Analytical procedures should be designed to detect at least part of any material error that has occurred. For example, comparing monthly contributions and benefits over several years is generally more useful than comparing annual contributions and benefits for the same period.

Exhibit 2-1 describes factors that affect the expected effectiveness of an analytical procedure.

Exhibit 2-1
Factors Affecting the Expected Effectiveness of an Analytical Procedure

- Nature of the Account.
- Nature of the Assertion Being Tested. (Analytical procedures can be more effective than tests of details for testing the completeness assertion.)
- Likely Cause of Potential Misstatement. (Analytical procedures tend to be more effective when the risk of misstatement is assessed as being primarily from error rather than from fraud.)
- Degree to Which the Data to Which the Analytical Procedure is Applied are Related to one another.
- The Stability of the Client Environment. (Analytical procedures are generally more effective in a stable environment.)
- Existence of Offsetting Factors that affect the amount being tested.
- The Source and Reliability of Data Used in the Test. (Examples of reliable data include internal financial information from comparable prior periods, budgets, extrapolations from interim or annual data, or data developed under a reliable system with adequate controls; internal nonfinancial or operating data from sources independent of those responsible for the amount being audited; and external industry statistics or comparable plan data.)
- The Level of Detail Used to Develop the Expectation. (For instance, a more effective test generally results from use of monthly rather than annual data, or data by investment or employer rather than plan-wide data.)

* * *
Examples of Analytical Procedures. The types of analytical procedures applied will vary with the auditor’s previous experience with the plan, the nature and materiality of the accounts involved, and the nature of financial and other nonfinancial data available. Although common ratios can be very helpful, they cannot substitute for professional judgment. As conditions change from one plan to another or one period to another, the auditor must challenge any standard checklist or list of prior-period procedures. However, the following paragraphs give some examples of analytical procedures that may be appropriate in certain circumstances.

Trend analysis compares either the absolute dollar amount or percentage change in accounts over time. When the auditor reads comparative financial statements and questions the fluctuations in accounts between years, he is applying a form of trend analysis. Other examples include comparing monthly contributions and benefits for the current period with those of prior periods or analyzing a five-year contribution and benefit trend.

Reasonableness tests estimate a financial statement amount or the change in an amount from the prior year. Some reasonableness tests involve ratios. For example, the reasonableness of investment income can be estimated by dividing income by the average investment during the period. Other reasonableness tests involve estimating account balances by using nonfinancial data. For example, the reasonableness of benefits can be evaluated by dividing the total benefits paid by the average number of retired participants during the period.

Ratio analysis involves the study of the relationship between two financial statement amounts. Some of the common ratios and relationships considered for employee benefit plans are as follows:

a. Contribution Ratios. These ratios help determine contribution trends and the reasonableness of contributions when compared to prior periods and to other applicable criteria. Some of the common contribution ratios include:

(1) Contributions per Active Employee for the Period—used to review the reasonableness of the employer and employee contributions for each active employee for the current period and when compared to prior periods. The ratio can be computed using the total number of employees or the total number of active participants and can be useful for both retirement and health and welfare plans.

(2) Contributions as a Percentage of Total Compensation—used to review the reasonableness of the employer and employee contributions in relation to total compensation for the current period and when compared to prior periods. The ratio can be computed using total compensation for all employees or total compensation for just the participants and can be useful for both retirement and health and welfare plans. This ratio is generally used only for single employer plans but can be used for multi-employer plans if the information is available.

(3) Contributions for Each Eligible Hour—used to review the reasonableness of the employer and employee contributions in relation to eligible hours for the current period and when compared to prior periods. This ratio is especially useful when contributions are based on an amount per eligible hour usually based on a collective bargaining agreement and can be useful for both retirement and health and welfare plans.

(4) Employer Contribution as a Percentage of Net Income—used to review the reasonableness of the employer contribution in relation to the net income of the sponsor for the current period and when compared to prior periods. This ratio is generally used only for single employer plans but can be used for multiemployer plans if the information is available. It is generally useful only for retirement plans.

(5) Employer Matching Contributions as a Percentage of Employee Contributions—used to review the reasonableness of employer matching contributions in relation to employee contributions for the current period and when compared to prior periods. This ratio is generally used only for contributory retirement plans that feature employer matching of employee contributions.

b. Investment Ratios. These ratios help assess the effectiveness of the investment program. Some of the common investment ratios include:

(1) Investments as a Percentage of Total Assets—indicates how efficient the plan invests its assets. The greater the percentage, the stronger the plan. This ratio is useful for all types of plans.
(2) *Return on Investments*—indicates the effectiveness of the investment program. This ratio is useful for all types of plans.

(3) *Return on Total Assets*—indicates the effectiveness of the investment strategy and the investment program. This ratio is a combination of the previous two and is used by some auditors in lieu of the other two. This ratio is useful for all types of plans.

c. **Benefit Ratios**—*Retirement Plans.* These ratios help assess benefit trends and the reasonableness of benefit amounts when compared to prior periods and when compared to other applicable criteria. Some of the common benefit ratios include:

(1) *Average Benefit Payment per Retired Participant*—used to review the reasonableness of the average benefit payment for each retired participant for the current period and when compared to prior periods.

(2) *Vested Benefit per Retired Participant*—used to review the reasonableness of the average vested benefit for each retired participant at the end of the current period and when compared to prior periods.

(3) *Vested Benefit per Active Employee*—used to review the reasonableness of the average vested benefit for each active employee at the end of the current period and when compared to prior periods.

(4) *Average New Benefit Payments to New Retirees*—used to review the reasonableness of the average retirement payments to new retirees for the current period and when compared to prior periods.

d. **Health and Welfare Plan Claims and Premium Ratio.** These ratios help assess benefit trends and the reasonableness of claim amounts when compared to prior periods and to other applicable criteria. Some of the common ratios include:

(1) *Premium Expense per Participant in an Insured Plan*—used to review the reasonableness of the premium expense for each active participant based on the average number of participants during the current period and when compared to prior periods.

(2) *Claim Expense per Participant in an Uninsured Plan*—used to review the reasonableness of claim expense for each active participant based on the average number of participants during the current period and when compared to prior periods.

(3) *Claims Payable per Participant in an Uninsured Plan*—used to review the reasonableness of claims payable for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(4) *Estimated Liability for Claims Incurred But Not Reported per Participant*—used to review the reasonableness of the estimated liability for claims incurred but not reported for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(5) *Postretirement Benefit Obligation per Participant*—used to review the reasonableness of the estimated postretirement benefit obligation for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(6) *Postemployment Benefit Obligation per Participant*—used to review the reasonableness of the estimated postemployment benefit obligation for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

The calculations for these ratios are presented in Exhibit 2-2. In addition, *PPC’s Workpapers ™ for Employee Benefit Plan Audits*, are Excel®-based practice aids and templates that may be used to automatically calculate many of the ratios discussed in this section. Macros have also been utilized to simplify rolling forward information from year to
year. For order information, please call (800) 323-872. Ratios should not be computed just for the sake of computing them. Generally, auditors should select only those ratios that provide information about assertions or accounts that are considered significant.

Exhibit 2-2

Common Activity Ratios—Employee Benefit Plans

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Computation</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Plans:</td>
<td></td>
</tr>
<tr>
<td>Contribution per active employee for the period</td>
<td>Contributions</td>
</tr>
<tr>
<td>Contribution as a percent of total compensation</td>
<td>Average Number of Active Employees</td>
</tr>
<tr>
<td>Contribution for each eligible hour</td>
<td>Total Compensation</td>
</tr>
<tr>
<td>Employer contribution as a percent of net income</td>
<td>Contributions</td>
</tr>
<tr>
<td>Invested assets as a percent of total assets at end of period.</td>
<td>Total Eligible Hours</td>
</tr>
<tr>
<td>Return on investments for the period</td>
<td>Employer Contributions</td>
</tr>
<tr>
<td>Return on assets for the period</td>
<td>Employer Net Income Before Income Taxes</td>
</tr>
<tr>
<td>Retirement Plans:</td>
<td></td>
</tr>
<tr>
<td>Average benefit payment per recipient for the period.</td>
<td>Benefit Payments</td>
</tr>
<tr>
<td>Vested benefits per retired employee at end of period</td>
<td>Average Number of Recipients</td>
</tr>
<tr>
<td>Vested benefits per active employee at end of period</td>
<td>Actuarial Present Value of Vested Benefits</td>
</tr>
<tr>
<td>Average new benefit payments to new retirees</td>
<td>Number of Retired Employees</td>
</tr>
<tr>
<td>Employer matching contributions as a percent of employee contributions</td>
<td></td>
</tr>
<tr>
<td>Health and Welfare Plans:</td>
<td></td>
</tr>
<tr>
<td>Premium expense per participant in an insured plan</td>
<td>Insurance Premium Expense</td>
</tr>
<tr>
<td>Claim expense per participant in an uninsured plan</td>
<td>Average Number of Participants</td>
</tr>
<tr>
<td>Claims payable per participant in an uninsured plan</td>
<td>Claims Expense</td>
</tr>
<tr>
<td>Estimated liability for claims incurred but not reported per participant</td>
<td>Claims Payable</td>
</tr>
<tr>
<td></td>
<td>Number of Participants</td>
</tr>
<tr>
<td></td>
<td>Estimated Liability</td>
</tr>
<tr>
<td></td>
<td>Number of Participants</td>
</tr>
</tbody>
</table>

230
Ratio

Postretirement benefit obligation per participant
Postemployment benefit obligation per participant

Computation

Postretirement Obligation
Number of Participants
Postemployment Obligation
Number of Participants

Evaluating the Results of Analytical Procedures. Results of analytical procedures are usually evaluated against a plan’s past performance, taking into account expected performance. Professional judgment must be applied in deciding when the results of analytical procedures indicate significant fluctuations from expected amounts that should be investigated further. It is recommended that auditors determine the magnitude of changes that will be considered significant before applying analytical procedures so that those judgments will be as objective as possible. In making that decision, the following factors usually should be considered:

a. Expected Size of the Fluctuation. Some fluctuation from prior years (or expected results) often would be considered reasonable based on the plan and the circumstances. However, fluctuations in excess of expected amounts generally should be considered significant.

b. Materiality. Fluctuations should be considered in light of materiality for the financial statements, by financial statement line as well as in the aggregate.

c. Percentage Change. Usually the percentage change rather than the absolute amount of the change should be considered in deciding whether a change in an account balance is significant, especially in smaller accounts.

d. Precision of the Analytical Procedure. Relationships that are more direct and involve fewer variables can be expected to provide more accurate estimates of actual account balances.

When the Fluctuations from Expected Amounts Are Significant. When fluctuations from expected amounts are significant, the auditor should reconsider the methods used to develop the expectation and the plausibility of the relationships. Discussions with management may provide explanations for the variances. However, in most instances, auditors will combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations. If the fluctuations cannot be explained, the auditor should perform other audit procedures to determine if the differences are likely misstatements.

The auditor should document the matters covered in the analytical procedures. Although not required, many auditors document analytical procedures, particularly the results of ratio and trend analysis, in carryforward workpapers or in a permanent file to facilitate historical comparisons.

Limitations of Analytical Procedures. Applying analytical procedures can be an effective method of identifying misstatements in financial statements. However, they do have certain limitations, including the following:

a. Inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving estimates, because relationships are unpredictable. Similarly, it is difficult to obtain assurance about the assertions of existence or ownership through analytical procedures.

b. Analytical procedures are ineffective when factors affecting accounts are not constant over time.

c. Analytical procedures are less precise and accurate as account relationships become more remote.

d. Reasonableness tests usually depend to some extent on operating data, which may not be available.
e. Ratios may not be comparable with industry statistics, with ratios computed for other clients, or within the same client over time because of changes in accounting principles or because of differences in the way they are computed.

**Required Documentation.** When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, SAS No. 56, *Analytical Procedures* (AU 329.22) requires the auditor to document:

- the expectation and the factors considered in its development (unless readily determinable from the work performed),
- the results of comparing recorded amounts to the expectation, and
- any additional procedures performed in response to significant unexpected differences and the results of those procedures.

Although not required by authoritative literature, documentation might also include information about the auditor’s approach to evaluating the significance of the difference between the recorded amount and the expectation (e.g., a percentage of tolerable misstatement).

**Terminating Plans**

For an audit or a benefit plan that is terminating with final benefits being paid during the current audit period, the auditor should consider performing the following procedures, in addition to the procedures discussed previously in this lesson.

a. Read the plan agreement to understand how the plan is to be terminated, including how final payments should be calculated and what happens to any remaining plan assets.

b. Test the final payments to determine that only eligible payees were paid and that the amounts were properly calculated. According to IRC Sec. 411(d)(3), benefits should be calculated based on all participants being 100% vested.

c. Determine that the transactions are recorded in the proper account and period.

d. If any remaining plan assets revert back to the plan sponsor, determine that the reversions comply with the plan provisions and IRS regulations.

e. If the plan is a defined benefit plan subject to the provisions of the PBGC, determine that all notices required by the PBGC were made on a timely basis.

f. Determine that the liquidation basis of accounting is used to prepare actuarial valuations, if any.

**Partial Terminations.** Partial terminations may occur if 20% or more of the plan participants are terminated because of an action taken by the plan sponsor, such as closing a plant, terminating a product or line of products, or downsizing. If the auditor is considering whether a partial termination has occurred, it may be necessary to consult with the plan’s legal counsel or other qualified legal counsel.

If a partial termination occurs, full vesting is required for the part of the plan that has been terminated, but not for the entire plan. Therefore, the terminated participants are to be considered fully vested, but the remaining participants’ vesting status should continue to be determined according to the plan provisions.

**Changes in Service Organizations**

Plan administrators may change service organizations to reduce administrative expenses, offer participants improved services, improve the accuracy or efficiency of services, or for other reasons. Due to the competition among third-party service organizations such as trustees, recordkeepers, and custodians, it is not uncommon for plans to change service organizations. Auditors should be alert for any change in service organizations when performing the audit planning.
If the plan changes service organizations during the period under audit, additional procedures are usually necessary to ensure the proper transition of assets, records, etc. from the former or predecessor service organization to the new or successor service organization. One of the first procedures is to obtain an understanding of the control environment for each of the service organizations.

If the service organization provides trustee or custodian services, the auditor should agree or reconcile total plan assets per the predecessor organization immediately prior to the transfer to the total plan assets of the successor organization immediately after the transfer.

If the change in service organizations occurred at the beginning or end of the plan’s fiscal year, only the service organization performing services during that period for the plan should be considered for testing. However, many plans change service organizations during the plan year to avoid transition issues at or close to year-end. If the change occurs during the period, the auditor should consider each of the service organizations when selecting transactions or services for testing.

**Defined Contribution Plans.** If the service organization performs record keeping functions, the auditor should agree the total of all participant accounts per the predecessor organization immediately prior to the transfer to the total of all such accounts per the successor organization immediately after the transfer. In addition, the auditor should consider selecting individual participant accounts to verify the individual account balances before transfer to the balances after the transfer. If the plan offers participant-directed investments, the auditor should also agree the participant’s individual investment balances before the transfer to his or her selected investments after the transfer.

A defined contribution plan may change both the record keepers and trustees/custodians. In this situation, the auditor should also agree or reconcile the total of all participant accounts per the record keeper to the plan's net assets per the trustee/custodian before and after the transfer.
SELF-STUDY QUIZ

37. Which of the following accurately describes a reasonableness test?

   a. A contrast of either the absolute dollar amount or percentage change in accounts over time.
   b. An approximation of a financial statement amount or the fluctuation in an amount from the prior year.
   c. An examination of the association between any two financial statement amounts.

38. When planning analytical procedures for the defined benefit plan audit of Company XYZ, which of the following should be used to review the reasonableness of the average vested benefit for each active employee at the end of the current period and when compared to prior periods?

   a. Contribution ratio.
   b. Investment ratio.
   d. Health and welfare plan claims and premium ratio.

39. Which of the following statements is an accurate statement regarding limitations on analytical procedures in identifying misstatements in financial statements?

   a. Inquiries are equally effective for all assertions and accounts.
   b. Analytical procedures are ineffective when factors affecting accounts are not consistent over time.
   c. Analytical procedures remain consistently precise/accurate even when account relationships become more remote.
   d. Reasonableness tests do not depend on operating data.

40. Company C’s defined contribution plan changed trustees on 7/1/09. The plan’s fiscal year ended 12/31/09. What additional audit procedures must be performed that would not have been required if the plan had changed trustees effective 1/1/10?

   a. Reconcile total plan assets per the predecessor trustee before the transfer to the total plan assets per the successor trustee after the transfer.
   b. Agree the participant account totals per the predecessor recordkeeper prior to the transfer to the participant account totals per the successor recordkeeper after the transfer.
   c. Consider both the predecessor and successor trustees when selecting transactions for testing.
   d. Reconcile total participant accounts per recordkeeper to the plan’s net assets per the trustee before and after the transfer.
SELF-STUDY ANSWERS

37. Which of the following accurately describes a reasonableness test? (Page 228)

   a. A contrast of either the absolute dollar amount or percentage change in accounts over time. [This answer is incorrect. A comparison of either the absolute dollar amount or percentage change in accounts over time is a description of a trend analysis.]

   b. An approximation of a financial statement amount or the fluctuation in an amount from the prior year. [This answer is correct. An estimate of a financial statement amount or the change in an amount from the prior year is a description of a reasonableness test. Such a test can be used to estimate account balances by the use of nonfinancial data.]

   c. An examination of the association between any two financial statement amounts. [This answer is incorrect. The study of the relationship between any two financial statement amounts is a description of a ratio analysis.]

38. When planning analytical procedures for the defined benefit plan audit of Company XYZ, which of the following should be used to review the reasonableness of the average vested benefit for each active employee at the end of the current period and when compared to prior periods? (Page 228)

   a. Contribution ratio. [This answer is incorrect. Contribution ratios are used to help in determining contribution trends and the reasonableness of contributions when compared to prior periods and to other applicable criteria.]

   b. Investment ratio. [This answer is incorrect. Investment ratios assist the auditor in assessing the effectiveness of the investment program.]

   c. Benefit ratios—Retirement Plans. [This answer is correct. Benefit ratios for retirement plans help the auditor to assess benefit trends and the reasonableness of benefit amounts when compared to prior periods and when compared to other applicable criteria. One such benefit ratio is the vested benefit per active employee that is used to review the reasonableness of the average vested benefit for each active employee at the end of the current period and when compared to prior periods.]

   d. Health and welfare plan claims and premium ratio. [This answer is incorrect. Health and welfare plan claims and premium ratios are used in assessing benefit trends and the reasonableness of claim amounts when compared to prior periods and to other applicable criteria.]

39. Which of the following statements is an accurate statement regarding limitations on analytical procedures in identifying misstatements in financial statements? (Page 231)

   a. Inquiries are equally effective for all assertions and accounts. [This answer is incorrect. One limitation of analytical procedures in identifying misstatements in financial statements is that inquiries may be more effective for certain assertions or accounts than for others.]

   b. Analytical procedures are ineffective when factors affecting accounts are not consistent over time. [This answer is correct. When factors affecting accounts are not consistent over time, analytical procedures are ineffective since analytical procedures expect a trend in results.]

   c. Analytical procedures remain consistently precise/accurate even when account relationships become more remote. [This answer is incorrect. Analytical procedures are less precise/accurate as account relationships become more remote which is a limitation for analytical procedures when attempting to identify misstatements in financial statements.]

   d. Reasonableness tests do not depend on operating data. [This answer is incorrect. Another example of a limitation on analytical procedures is that reasonableness tests usually do depend in part on operating data which may not be available to examine.]
40. Company C’s defined contribution plan changed trustees on 7/1/09. The plan’s fiscal year ended 12/31/09. What additional audit procedures must be performed that would not have been required if the plan had changed trustees effective 1/1/10? (Page 233)

   a. Reconcile total plan assets per the predecessor trustee before the transfer to the total plan assets per the successor trustee after the transfer. [This answer is incorrect. This procedure must be performed whenever there is a change in the plan trustee regardless of when the change occurred in the plan year.]

   b. Agree the participant account totals per the predecessor recordkeeper prior to the transfer to the participant account totals per the successor recordkeeper after the transfer. [This answer is incorrect. This step is not necessary unless the plan changed recordkeepers during the period under audit.]

   c. Consider both the predecessor and successor trustees when selecting transactions for testing. [This answer is correct. Since the plan’s transactions were processed by two different trustees during the plan year, samples of both trustees’ transactions should be tested.]

   d. Reconcile total participant accounts per recordkeeper to the plan’s net assets per the trustee before and after the transfer. [This answer is incorrect. Only net assets per the trustee need to be reconciled before and after the transfer, since the plan’s recordkeeper didn’t change during the period under audit.]
EXAMINATION FOR CPE CREDIT

Lesson 2 (EBPTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

29. Which of the following would be classified as an outside service organization qualified to make benefit distributions?
   a. Real estate broker.
   b. Commodities trader.
   c. Insurance company.
   d. Independent auditor.

30. Which of the following is a common audit procedure for verifying that benefit payments were terminated when a recipient dies?
   a. The auditor should look for participants that are no longer contributing to the plan.
   b. The auditor can scan the obituaries of local papers where participants live.
   c. The auditor can randomly contact participants for verification.
   d. The auditor can examine the bank reconciliations for long-outstanding benefit checks.

31. After the auditor has assessed the completeness of census data and how appropriate the plan provisions are that the actuary used in the defined benefit retirement plan actuarial determination, the auditor should consider whether the actuary’s assumptions and methods conform to ERISA requirements and to:
   a. The auditor’s SAS No. 70 report.
   b. FASB ASC 960.
   c. SOP 92-6, as amended.
   d. AU 543.

32. Tara is needing to verify that the actuary has not attached any qualifications to the defined benefit plan that she is currently auditing. Where would Tara locate this information in the Form 5500?
   a. Schedule B.
   b. Schedule D.
   c. Schedule E.
   d. Schedule F.

33. Under GAAP, the financial statements of health and welfare benefit plans should include the actuarial present value of all of the following benefit obligations, as applicable, except:
   a. Anticipated eligibility credits.
   b. Claims incurred but not reported (IBNR) to the plan.
   c. Premiums payable to insurance companies.
   d. Postemployment benefits (less current amounts payable) for active participants.
34. Under defined benefit health and welfare plans, which of the following obligation descriptions is stated accurately?
   
a. Financial statements of uninsured plans do not include obligations for claims payable for active and retired participants.

b. Financial statements of uninsured plans include obligations for premiums.

c. The IBNR for active participants is included in the postretirement benefit obligation.

d. Insured plans do not report obligations for claims payable.

35. When auditing a health and welfare plan, an auditor should express a qualified or adverse opinion due to a material departure from GAAP in which of the following circumstances?
   
a. The actuarial present value of benefit obligations disclosure is materially inadequate.

b. The actuarial present value of benefit obligations disclosure is based on management’s estimates.

c. The actuarial present value of benefit obligations disclosure is based on calculations performed by an actuary.

d. The auditor decides to consult an actuary to evaluate the reasonableness of management’s estimates and the plan refuses to provide the actuary with the necessary data.

36. Which of the following types of employee benefit plans is most likely to own or lease operating assets?
   
a. Small, single-employer plans.

b. Large, single-employer plans.

c. Multiemployer plans.

d. Plans using third-party administrators.

37. At what value, less any accumulated depreciation, are property and equipment used in plan operations carried, provided that the assets are not impaired?
   
a. Cost.

b. Fair value.

c. Market value.

d. Trade value.

38. Of the following, which is considered most effective in the decision-making process concerning potential misstatements?
   
a. Professional judgment.

b. Trend analysis.

c. Reasonableness.

d. Ratio analysis.
39. Which of the following is classified as an investment ratio?
   a. Employer contribution as a percentage of net income.
   b. Return on total assets.
   c. Average new benefit payments to new retirees.
   d. Postemployment benefit obligation per participant.

40. Auditors should determine changes that need to be considered before applying analytical procedures to a plan’s past performance as compared to expected performance. Which of the following factors does not accurately reflect information that should be considered?
   a. Any fluctuation from expected amounts.
   b. Materiality.
   c. Percentage change.
   d. Precision of the analytical procedure.
GLOSSARY

**Collective trust**: An investment fund formed from the pooling of investments by institutional investors.

**Common trust fund**: A common trust fund is similar to an open-end investment company or mutual fund but participation is limited to those with trust accounts.

**Deferred group annuity**: Retirement income payments for an employee that begin after a stipulated future time period, and continue for life. Each year contributions are used to buy a paid-up single-premium deferred annuity. These increments, added together, provide income payments at retirement.

**Deposit administration (DA) contract**: A contract administered by a life insurance company where pension funds accumulate in a master group annuity policy until a participant retires. As plan members retire, individual annuity policies are purchased with money from the fund.

**Derivative instrument**: A financial instrument which derives its value from the value of some other financial instrument or variable.

**Discretionary trust**: A trust where the beneficiaries and/or their entitlements to the trust fund are not fixed, but are determined by the criteria set out in the trust instrument by the settlor.

**DOL**: Department of Labor.

**DOL limited scope audit**: A DOL limited-scope audit is allowed when regulated and supervised assets held by banks or insurance companies are subject to periodic examination by state or federal agencies. Such an audit allows the auditor to rely on information related to plan investments and transactions that is prepared by the financial institutions and certified to be both complete and accurate.

**Employee Benefits Security Administration (EBSA)**: In February 2003, the Pension and Welfare Benefits Administration (PWBA) was renamed the Employee Benefits Security Administration (EBSA). The EBSA is a division of the Department of Labor (DOL) charged with enforcing the rules governing the conduct of plan managers, the investment of plan assets, the reporting and disclosure of plan information, the fiduciary provisions of the law, and workers’ benefit rights.

**ERISA**: Employee Retirement Income Security Act is an American federal statute that establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans.

**Fair value**: A rational and unbiased estimate of the potential market price of a good, service, or asset, taking into account such factors as relative scarcity, perceived utility, risk characteristics, replacement costs (or costs of close substitutes), and production/distribution costs (including a cost of capital).

**Fiduciary**: A person, company, or association holding assets in trust for a beneficiary.

**Guaranteed investment contract (GIC)**: A contract that guarantees repayment of principal and a fixed or floating interest rate for a predetermined period of time. Guaranteed investment contracts are typically issued by life insurance companies and marketed to institutions qualified for favorable tax status under the Internal Revenue Code (for example, 401(k) plans).

**IBNR**: Incurred but not reported. When a policy of general insurance is written it will typically cover a 12 month period from inception of the policy. When the policy is sold, a premium is paid by the insured party to the insurer. The number and cost of claims that will arise from the policy are unknown and unknowable amounts at inception. Indeed, at expiry of the policy there can be a high degree of uncertainty as to what the cost of claims will ultimately be.

**Immediate participation guarantee (IPG) contract**: A group insurance contract under which the employer’s unallocated account is credited with its share of actual investment income for the year. There is generally no guarantee of principal or a minimum rate of interest. Annuity payments are charged directly against the account as they are paid.
**Market value:** Market value (or market price) is the price at which buyers and sellers trade similar items in an open marketplace.

**Master trust:** A collection of funds from individual investors that are pooled together in order to obtain wholesale prices and rates unavailable for regular investors.

**Mutual fund:** A professionally-managed form of collective investments that pools money from many investors and invests it in stocks, bonds, short-term money market instruments, and/or other securities.

**Nondiscretionary trust:** A trust in which the trustee does not have the right to determine how and when distributions are made to the beneficiary.

**Omnibus account:** An account that one futures commission merchant carries for another in which the transactions of multiple individual account holders are combined.

**Postemployment benefits:** Postemployment benefits are all types of benefits provided to former or inactive employees, their beneficiaries, and covered dependents. Those benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage.

**Postretirement benefits:** Postretirement benefits are not gratuities but are part of an employee’s compensation for services rendered.

**Ratio analysis:** The calculation and comparison of ratios which are derived from the information in a company’s financial statements.

**Third-party administrator:** The processing of claims is outsourced to another company but the risk of loss remains with the insurer or the employer.

**Trend analysis:** The concept of collecting information and attempting to spot a pattern, or trend, in the information.

**Synthetic guaranteed investment contract:** Modified Guaranteed Investment Contract (GIC) in which the underlying assets of the synthetic contract are owned by the plan itself rather than the insurance company as is the case with the GIC.

**Trust:** A fiduciary relationship in which a person, called a trustee, holds title to property for the benefit of another person, called a beneficiary.
INDEX

ACCOUNTING STANDARDS

A

ACCOUNTS PAYABLE (FOR SECURITIES PURCHASED, MANAGEMENT FEES, AND OPERATING EXPENSES)
Audit procedures ........................................... 222

ANALYTICAL PROCEDURES

A

AUTHORITATIVE LITERATURE

B

BENEFIT OBLIGATIONS

B

BENEFIT PAYMENTS

B

CASH

C

CONTRIBUTIONS RECEIVED AND RECEIVABLE

D

DEPARTMENT OF LABOR (DOL)

D

DERIVATIVES

E

ESOP

E

INSURANCE AND INVESTMENT CONTRACTS

I

INVESTMENTS

I

LOANS PAYABLE

L

MULTIEMPLOYER PLAN

M
OPERATING (ADMINISTRATIVE) EXPENSES
• Audit procedures ........................................ 223

OPERATING ASSETS (PROPERTY AND EQUIPMENT)
• Audit procedures ........................................ 222

PARTICIPANT DATA
• Audit procedures ........................................ 192
  • Defined benefit plan ................................. 192, 195
  • Defined contribution plan ......................... 192, 195
  • Employee contributions ............................ 192
  • Multiemployer plan ................................. 192, 196
  • Withdrawals, terminations, and forfeitures ...... 192, 195

SERVICE PROVIDERS
• Changes in and related audit procedures ............ 232
CONCLUDING THE AUDIT (EBPTG103)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses the general and concluding procedures that are unique to an employee benefit plan audit. Lesson one addresses the effect commitments and contingencies have on the conclusion of the audit. Lesson two explains the use of the management representation letter, workpapers, and how risk assessment affects the requirements of the auditor as they are concluding the audit. Finally, lesson three describes the required communication by the auditor to those charged with governance and the auditor’s responsibility for the preparation of the financial statements and supplemental schedules.

PUBLICATION/REVISION DATE: February 2010

RECOMMENDED FOR: Users of PPC’s Guide to Audits of Employee Benefit Plans

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing.

CPE CREDIT: 7 QAS Hours, 7 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by February 28, 2011

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—The Effect of Commitments on the Conclusion of the Audit

Completion of this lesson will enable you to:

- Determine the effect of tax plan status and tax violations on a benefit plan audit and the information to request in a legal representation letter.
- Identify subsequent events procedures, define related parties and parties in interest and their effect on the audit and assess going concern under SAS No. 59.

Lesson 2—The Use of the Management Representation Letter, Workpapers and Risk Assessment on Concluding the Audit

Completion of this lesson will enable you to:

- Determine the requirements of the management representation letter and how audit adjustments, and changes in management affect its issuance.
- Describe the procedures used at the conclusion of the audit to reevaluate the assessment of risk.
- Discuss the review of workpapers in concluding a benefit plan audit and how the evaluation of material misstatement affects the concluding audit procedures.
Lesson 3—The Preparation of Financial Statements and the Required Communication from the Auditor

- Determine the auditor’s responsibility for the financial statements and the required supplemental schedules.
- Discuss the communication that is required by the auditor to those charged with governance concerning internal control, the resulting deficiencies, and the methods and timing of expected communications.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
EBPTG103 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.
Lesson 1: The Effect of Commitments on the Conclusion of the Audit

INTRODUCTION

In addition to the audit procedures for specific account balances or transaction classes, other procedures that are more general in nature are necessary. This lesson discusses the aspects of general and concluding procedures that are unique to an employee benefit plan audit. The following matters are discussed:

- Commitments and contingencies, including the plan’s tax status and the legal representation letter.
- Subsequent events.
- Related parties, parties in interest, and prohibited transactions.
- Going concern considerations.
- The management representation letter.
- Considering accumulated results of audit procedures.
- Analytical procedures.
- Review of workpapers.
- Summarization and evaluation.
- Drafting the financial statements, required supplemental schedules, and auditor’s report.
- Other audit communications, including internal control related matters, communication with the audit committee (or those charged with governance), and communication of prohibited transactions, fraud, and other illegal acts.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the effect of tax plan status and tax violations on a benefit plan audit and the information to request in a legal representation letter.
- Identify subsequent events procedures, define related parties and parties in interest and their effect on the audit and assess going concern under SAS No. 59.

COMMITMENTS AND CONTINGENCIES

The primary audit objectives for commitments and contingencies are discovering their existence, assessing their financial statement effect, and evaluating the adequacy of their disclosure. In June 2008, the FASB issued an Exposure Draft titled Disclosure of Certain Loss Contingencies. The objective of the proposed Standard is to enhance the disclosure requirements for loss contingencies under FASB ASC 450 (formerly SFAS No. 5, Accounting for Contingencies). At the date of this lesson, the FASB was redeliberating issues identified during the exposure period and planned to issue a final Standard in the second quarter of 2010. The effective date has not yet been determined. Auditors should be alert for issuance of the final Standard. Examples of commitments and contingencies of concern to an employee benefit plan auditor are as follows:

- Pending or threatened litigation or unasserted claims.
- Loans or leases in default and reportable to the DOL.
Events reportable to the Pension Benefit Guarantee Corporation.

Events that may jeopardize the plan’s tax qualification status.

Purchase commitments, including commitments to acquire investments.

Possible losses on long-term contracts.

Long-term leases with required fixed payments for several years.

Contingent liability to return defined contribution plan employer contributions in excess of the tax deductible limits to the employer.

Financial transactions or arrangements with financial institutions, for example, oral or written guarantees, etc.

IRS examinations in progress related to tax qualification status or taxes on unrelated business income.

Noncompliance with laws, regulations, or plan provisions, including communications from the IRS, DOL, or other regulatory agencies concerning violations or possible violations of such laws, regulations, or provisions or results of an agency’s audit or investigation of plan activities or filings.

Review or inquiry by DOL or IRS relative to a request for a prohibited transaction exemption.

Fraud involving plan management or personnel that could affect the financial statements.

Prohibited party-in-interest transactions.

Designation as a potentially responsible party by the Environmental Protection Agency.

**Audit Procedures**

The auditor may be aware of possible commitments or contingencies from knowledge of the plan’s activities gained during audit planning and from reading minutes, contracts, agreements, or other documents. Some commitments or contingencies may be discovered as a result of audit procedures applied to specific account balances or transaction classes. For example, lease commitments may be discovered during the audit of rent and other lease payments, and compensating balance or debt guarantee arrangements may be disclosed in specific confirmation responses received from lenders.

The auditor may decide to send confirmation letters to financial institutions to confirm or discover details of financing arrangements, such as guarantees or other contingent liabilities. The auditor should specifically question the plan administrator, other plan management, and the plan sponsor about the possibility of unrecorded contingencies or commitments. The management and legal representation letters also provide evidence about commitments and contingencies. Special considerations and procedures are necessary with respect to plan tax status.

**Plan Tax Status**

There are IRS requirements for an employee benefit plan to be qualified as exempt from federal income taxes. Note that a plan must comply with ERISA provisions regarding minimum plan coverage, participation, vesting, etc., to be qualified as tax exempt. The tax rules in ERISA, Title II, mirror the statutory laws of ERISA, Title I. Thus, to a great extent, tax qualification and ERISA compliance considerations merge. Plans must qualify for tax exemption in both plan design and continuing operation. This requirement means that the plan must be properly designed and must operate in accordance with those provisions, tax laws, and regulations to continue to qualify. The IRS issues determination letters regarding the qualified status of retirement plans under Section 401(a) of the IRC and the status of related trusts under Section 501(a). Determination letters provide assurance to interested parties that the terms of an employer-sponsored retirement plan satisfy the IRC qualification requirements. Sponsors of individually designed plans must submit determination letter applications generally once every five years. Preapproved plans must submit applications once every six years.
Auditor’s Responsibility for Plan Tax Status. The auditor should consider the plan’s compliance with tax laws and regulations in planning and performing the audit. Authoritative auditing literature imposes two different types of responsibility for considering compliance with laws and regulations. These responsibilities depend on how non-compliance affects the financial statements. SAS No. 54 (AU 317), Illegal Acts by Clients, indicates that for laws and regulations that have an indirect effect on the statements, the auditor has a responsibility to be aware of possible violations. On the other hand, SAS No. 54 imposes a higher detection responsibility on the auditor for violations that have a direct and material effect on the financial statements. For direct and material effect violations, the auditor has the same type of responsibility as imposed by SAS No. 99 (AU 316), Consideration of Fraud in a Financial Statement Audit; that is, the auditor should design the audit to provide reasonable assurance of detecting violations.

Violations of tax laws and regulations applicable to employee benefit plans have an indirect effect on the plan’s financial statements. Thus, the auditor’s responsibility during the audit is to be aware of the possibility that violations of such laws and regulations may have occurred and to investigate any information coming to his or her attention that suggests that a violation has occurred. Plan financial statements generally do not include income tax expense or payables. The effect of the tax laws and regulations is indirect and arises from a contingency, that is, from the effect of violations on the plan’s tax status.

AEBP, Paragraph 12.01b, states that the audit objective is to determine proper recording or disclosure of any asserted or unasserted claims and assessments affecting plan assets resulting from the loss of tax exemption. SAS No. 54 (AU 317.06) states that some laws and regulations have an indirect effect that "is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality."

AEBP, Paragraph 12.02, requires the auditor to be aware of the possibility that violations of tax laws and regulations may have occurred. If specific information comes to his or her attention that provides evidence of possible violations affecting the financial statements, he or she should apply auditing procedures specifically directed at determining whether a violation has occurred. The paragraph also states the expectation that the auditor will inquire of, and obtain representations from, management about compliance with laws and regulations and prevention of violations that may cause plan disqualification.

If the audit procedures and discussions with plan management lead the auditor to believe a violation of a tax law or regulation has occurred, he should then determine the effect, if any, on the financial statements and the auditor’s report. Several questions should be considered in this determination including:

a. What is plan management doing to address the violation?

b. What communications, if any, has the plan had with the DOL or IRS?

c. Will plan management be able to correct the violation?

d. What is the probability of the IRS disqualifying the plan?

Regarding question d., the IRS normally prefers to work with plan management to correct violations and to prevent future violations. Disqualifying a plan normally reduces the benefits to the employees, which is not the IRS’s goal.

If the answers to the questions in the previous paragraph are positive, that is, if plan management is working with the IRS to correct the violation, and if it does not appear that the IRS will disqualify the plan, the violation should be adequately disclosed in the financial statements and possibly in an emphasis of a matter paragraph in the auditor’s report, but a qualified or adverse opinion would not appear necessary for that violation. However, if the violation is severe and plan management is not actively trying to make appropriate corrections, a modification of the auditor’s report may be necessary.

Audit Procedures for Plan Tax Status. AEBP, Paragraph 12.03a, gives as an example of a procedure for auditing plan tax status, review of the IRS determination letter [note, however, that the IRS does not issue determination letters for health and welfare benefit plans, although an IRC Section 501(c)(9) VEBA trust must file an application for tax exemption when it is established] or, if available, a letter from the plan’s qualified tax counsel. The paragraph also refers to reviewing any new IRS rulings if the plan has been amended.
However, recent tax laws and regulations have imposed new requirements for tax qualification, including complex rules for minimum number of participants, minimum plan coverage, and nondiscrimination. As a result, some plans require amendment to incorporate or meet the new requirements.

Plan administrative committees or boards of trustees may have issued resolutions or other documentation adopting changes necessary for complying with the new requirements. And, they may be operating the plan in accordance with those resolutions, even though the plan has not yet been formally amended to incorporate the changes. Even if the plan has been formally amended, it may not yet have an IRS determination letter relating to the amendments.

Thus, the auditor may not be able to simply look to the formal plan document or an IRS determination letter when considering tax qualification. Instead, if the plan has not been formally amended, the auditor should review the administrative or board resolutions or other documents supporting the new provisions under which the plan operates. He or she should also obtain a management representation of its intention to formally amend the plan and the content of the planned amendments.

If the plan has been formally amended but has not obtained a new IRS determination letter, the auditor should obtain management’s representation and, if available, the plan tax counsel’s opinion on whether the amended plan qualifies. The auditor should also consider the adequacy of disclosure about the situation. AEBP, Paragraph 12.03a, states that a note disclosure should be made if the plan was amended after the receipt of the latest determination letter disclosing that situation. The paragraph illustrates the following disclosure:

The plan obtained its latest determination letter on (date), in which the Internal Revenue Service stated that the plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code. The plan has been amended since receiving the determination letter. However, the plan administrator and the plan’s tax counsel believe that the plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code.

During other aspects of the audit, the auditor should keep in mind that the formal plan document may not reflect actual plan operations. For example, in testing benefit accruals, the auditor may not be able to look to the unamended plan’s benefit accrual formula. It may have been changed and documented in an administrative committee or board resolution. This possibility should be considered when reviewing plan documents, amendments, and minutes in the audit planning stage. The auditor should determine what provisions the plan is actually operating under and document them for reference during other audit stages. Some auditors may have their tax departments review the plan provisions with respect to qualification matters.

Other audit procedures for considering tax qualification include the following:

a. Ask the plan administrator whether there have been any activities, amendments, or operational decisions that would cause the plan to lose qualification or incur unrelated business income taxes. The management representation letter should include such a representation.

b. Review the results of other auditing procedures for indications of unrelated business income, violations of tax qualification requirements, or violations of laws and regulations, such as the following:

(1) Discrimination in favor of highly compensated employees.
(2) Plan benefits that exceed statutory limits.
(3) Contributions to the fund that were not used exclusively for the benefit of participants.
(4) The plan does not cover a nondiscriminatory group of employees.
(5) Noncompliance with employee stock ownership plan diversification rules.

The auditor should note that incurring unrelated business income will not necessarily result in loss of qualification, but will require a tax provision in the financial statements. AEBP, Paragraph 12.05, notes that health and welfare
plans and defined benefit pension plans are more likely than other types of plans to generate UBTI due to the nature of their income and investments. If a plan has to account for income taxes arising from UBTI, the discussion of FASB ASC 740-10 (formerly FIN 48, Accounting for Uncertainty in Income Taxes), in AEBP, Paragraph 12.06 may be relevant. FASB ASC 740-10 (formerly FIN 48) requires that computations of current and deferred income tax assets and liabilities only consider tax positions that more likely than not would be sustained if the taxing authority examined the positions.

The auditor or his tax department may decide to complete a tax qualification checklist, particularly if the plan does not have a current IRS determination letter.

**Legal Representation Letter**

ERISA provides that an employee benefit plan may be sued under ERISA. Participants may make claims for pension benefits against a plan and may sue for violation of their rights under ERISA. SAS No. 12 (AU 337), Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments, requires the auditor to send a letter of inquiry to the client’s legal counsel and evaluate the response. The auditor identifies lawyers who were consulted about litigation, claims, assessments, and tax qualification matters and should be inquired of. These lawyers are identified by reviewing client legal files, analyzing legal and professional fees and invoices, and inquiring of plan management. (These procedures are also performed to identify commitments and contingencies.) If the sponsor of a single-employer plan pays the plan’s legal expenses, it may be necessary to review files or invoices at the plan sponsor’s location.

If a lawyer was not consulted during the period, the auditor may not send a legal letter, but, according to an auditing interpretation at AU 9337.15–17, the written representation obtained from plan management should state that management is not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments and that a lawyer has not been consulted about such matters.

**Content of the Letter.** The legal letter asks the lawyer to provide or corroborate information about pending or threatened litigation, including its nature and progress to date, how the plan is responding or intends to respond, the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the amount or range of potential loss. This information needs to be obtained for each individual matter. With respect to unasserted claims, the lawyer is asked to comment on any possible unasserted claims specifically identified by management and to confirm that he will notify management of any unasserted claims that come to his attention that, in his judgment, must be disclosed in accordance with the requirements of SFAS No. 5, Accounting for Contingencies (FASB ASC 450). AEBP, Paragraph 12.09, states that the following matters unique to employee benefit plans may be considered for inclusion in the letter:

- Breach of fiduciary responsibilities.
- Prohibited party-in-interest transactions and other transactions prohibited by ERISA, including late remittances of employee deferral contributions or loan repayments.
- Loans or leases in default and reportable to the DOL.
- Events reportable to the PBGC.
- Events that may jeopardize the plan’s tax qualification status.
- Legal actions brought against the plan on behalf of plan participants and beneficiaries.
- Review or inquiry by the DOL, the IRS, or other regulatory agency of the plan’s activities or filings since the last audit.

The letter should specify a materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount should be some fraction of tolerable misstatement computed in audit planning. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors. The letter should request the lawyer to respond as of a date
reasonably close to the date of the auditor’s report, for example, within two weeks of the anticipated report date. If particularly volatile litigation proceedings exist, the auditor may decide to confirm the continued appropriateness of the lawyer’s response as of a date nearer to the report date. This follow-up may be oral or written.

There is a “long form” request for legal representation in which the lawyer is asked to comment on the completeness of client-prepared information about the details of each matter listed as pending or threatened litigation. The “long form” approach may be more efficient if the plan has both inside and outside legal counsel. The inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining outside counsel’s representations. There is also a “short form” request for legal representation in which the lawyer is asked to prepare information rather than comment on management’s list. This letter may be used only when the client represents that there are no unasserted claims or assessments that are probable of assertions and must be disclosed in accordance with FASB ASC 450 (formerly SFAS No. 5). This form is usually best suited for a small plan, especially if the plan does not have inside counsel.

**Evaluating Lawyers’ Responses.** In reviewing the lawyer’s response, the auditor should make sure it reflects the materiality limit specified, is as of the specified response date, and contains all items of information requested (if a short form request was sent). If the date of the response significantly differs from the date requested, the auditor should obtain an updated letter. Also, the auditor should carefully evaluate how the lawyer words the assessment of the probability of an unfavorable outcome. The auditor should decide whether the response is clear regarding a probable or remote outcome. Wording such as “the plan believes there is absolutely no merit to the litigation,” “the plan has a substantial chance of prevailing,” or “the plan will be able to assert meritorious defenses,” are not clear as to likelihood of outcome. In addition, lawyers’ responses that are unclear or amount to talking around the point without taking a solid position should be carefully evaluated by the auditor. For example, terms like *substantial chance* and *reasonable opportunity* indicate more uncertainty than an opinion that the plan will prevail. The term *meritorious defenses* means only that the defenses will not be summarily dismissed by the court.

In some instances, the attorney may limit his or her response in ways other than that specified by the original request. For example, instead of limiting the response based on a specified materiality limit the attorney may limit the response to cases in which six or more hours have been billed. In that situation, the auditor should assess the potential effect of the limitation on the attorney’s response. A limitation based upon billable hours is generally not appropriate because it does not necessarily correlate to the amount of the contingent liability. Consequently, if an attorney’s response has a billable hours limitation, the auditor will generally need to ask the client to have the attorney respond based on the materiality limits specified in the original request.

Some lawyers add statements in their responses to emphasize retention of the attorney-client and attorney work product privileges. An example of such statements follows:

```
[Name of Plan] has advised us that the request made in its letter to us is not intended to be a waiver of the attorney-client privilege relating to any information the Plan had furnished to us. Furthermore, be advised that our response to you should not be interpreted as a waiver of the work product privilege relating to any of our files involving [Name of Plan].
```

According to an interpretation at AU 9337.28–29, such comments in lawyers’ letters are not limitations on the scope of their responses. Thus, those comments should not affect the auditors’ evaluations.

Some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

```
Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the plan. We can only furnish information concerning those unasserted possible claims or assessments upon which the plan has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the plan’s listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.
```
According to an interpretation of SAS No. 12 (AU 9337.31–32), such language is not a limitation on the scope of the audit as long as the lawyer’s response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client’s obligation to make financial statement disclosure with respect to unasserted claims or assessments.

If the auditor obtains an oral response concerning matters covered by the audit inquiry letter, the auditor should document conclusions reached concerning the need to account for or disclose litigation, claims, and assessments.

Another important consideration is the effective date of the lawyer’s response. If the lawyer’s effective response is dated too long before the date of the auditor’s report, the auditor should consider getting an updated response, either oral or written. If the update is obtained orally, it should be documented in the workpapers. If significant matters (such as new litigation or significant developments relating to old litigation) are discovered in the oral update, a written update should be obtained from the attorney.

**Environmental Remediation Liabilities**

FASB ASC 410 (formerly SOP 96-1, *Environmental Remediation Liabilities*) provides accounting and auditing guidance related to environmental remediation liabilities. In general, that literature requires the plan to accrue environmental remediation liabilities when the criteria of FASB ASC 450 (formerly SFAS No. 5) are met.

**Applicability to Employee Benefit Plans.** Although typically thought of in relation to manufacturing plants or service stations, environmental remediation could be faced by an employee benefit plan. For example, entities are not just liable for cleaning up the waste they generated, disposed of, stored, or hauled—they may also be liable for cleaning up sites they did not contaminate. For example, if an employee benefit plan invests in real estate that was used for hazardous substance disposal by the previous owner, the plan may become liable for the site’s cleanup.

**Audit Procedures.** Audit procedures for environmental liabilities generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of board or administrative committee meetings, making inquiries of the client’s attorney, and making inquiries of the client). Auditors frequently obtain information about potential environmental liabilities through the lawyer’s response. If the client has been notified by a federal regulator that a potential liability exists for a site with which it is or has been associated, the auditor would normally question an assertion by the plan’s attorney that the risk of loss is other than probable.

Substantive procedures performed to audit a recorded environmental remediation liability will consist of (a) reviewing and testing the process used by management to develop the estimate, or (b) developing an independent expectation of the estimate, which usually requires the use of an environmental specialist. In some cases, a combination of the two approaches may be necessary.

**Risks and Uncertainties**

FASB ASC 275 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) requires disclosures about risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. The disclosures are grouped into the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Current vulnerability resulting from certain concentrations.

The first two areas do not require significant additional audit work because the disclosures are required in all financial statements and the information needed for the disclosures is readily available. However, for the other two areas, specific procedures may be necessary to determine that all required disclosures have been identified.
**Certain Significant Estimates.** One way of determining the existence of a significant estimate that requires disclosure is to answer the following questions:

- Was an estimate used in preparing the financial statements?
- Is there more than a remote possibility that the estimate will change by a material amount within one year from the date of the financial statements due to a condition that existed at the date of the financial statements?

Initially, an auditor’s objective is to determine whether all significant estimates have been identified. The next step is determining whether it is at least reasonably possible that an estimate will change in the near term. The term *reasonably possible* encompasses the entire range from “more than remote” to “less than likely.” It could be concluded that it is at least reasonably possible that almost any estimate could change. To conclude otherwise, auditors must conclude that there is only a *remote* chance of an estimate changing.

It is a good practice to document conclusions about estimates that could change, particularly if the decisions are difficult or contentious. Such documentation can be informal and can be done, for example, on the relevant workpaper or in a separate memo. If more formal checklist document can be used. The checklist serves as a memory jogger to assist in determining whether all estimates have been identified. Note that even if it is determined that the chances of an estimate changing are more than remote, the remaining criteria—“material amount,” “near term,” and “existing conditions,”—may still eliminate the need for disclosure.

Auditors should obtain representations in the management representation letter that all material estimates have been identified and properly disclosed in the financial statements.

**Current Vulnerability Resulting from Certain Concentrations.** The audit approach for concentrations is similar in many respects to the audit approach for significant estimates. That is, initially, the auditor’s objective is to determine whether all concentrations have been identified. If the auditor identifies concentrations, evaluation of disclosure can be documented on the relevant workpaper or by memo. One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact*, whereas for significant estimates, the threshold is material. Auditors may find that fewer concentrations require disclosure. That, however, is a matter of professional judgment based on the individual circumstances of each client.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. An auditor should keep in mind the current tax laws and regulations when performing an audit of a benefit plan. If noncompliance with the tax laws has an indirect effect on the financial statements of the plan, what is the auditor’s responsibility?
   
   a. The auditor does not have an obligation when the noncompliance has an indirect effect on the financial statements.
   
   b. The auditor should be knowledgeable of tax laws and regulations and be aware of any possible violations.
   
   c. The auditor should plan the audit to give reasonable assurance of detecting violations.
   
   d. The audit should provide a high level of assurance that the plan complies with tax laws and regulations.

2. Stephen is auditing the benefit plan of Tile Tools, Inc. He has discovered some violations of tax laws in his audit of the plan and has reported them to the plan management. Management is working with the IRS to correct the violations and prevent future violations. How should Stephen reflect this information in the plan’s financial statements, and or the auditor’s report?
   
   a. Stephen will need to modify his auditor’s report to disclose the situation.
   
   b. Stephen will issue a adverse opinion on the plan’s financial statements.
   
   c. Since Tile Tool’s plan management is working with the IRS to fix the issues, Stephen does not have to address them in his report.
   
   d. Stephen should adequately disclose the violation in the financial statements.

3. Which of the following should an auditor include in a legal representation letter request to a company’s lawyer about the company’s benefit plan?
   
   a. The letter should ask for all pending or threatened litigation, regardless of materiality.
   
   b. The auditor should stress in the letter to the lawyer that all communication should be in writing, so that the auditor can have it for their files.
   
   c. The letter should ask for the likelihood of an unfavorable outcome on all pending litigation and an estimate of the amount of potential loss.
   
   d. An auditor only needs to ask the lawyer for information on asserted claims against the company’s benefit plan.

4. Stephanie is auditing the benefit plan of Trade World, Inc. The company has a small benefit plan and does not retain inside legal counsel to help with its management. Stephanie is preparing a legal representation letter to send to the company’s lawyer. Which form should Stephanie prepare to send?
   
   
   b. “Short form” request for legal representation.
5. If an employee benefit plan has an investment that could cause an environmental liability, how are the audit procedures modified by the auditor?

   a. An environmental specialist may be needed for the auditor to create an expectation of the estimate of the environmental liability.
   
   b. The auditor is usually informed of potential environmental liabilities by notification from a federal regulator.
   
   c. The audit procedures for environmental liabilities are vastly different than those for contingent liabilities since there are so many laws governing the environment.
   
   d. Additional audit procedures will not be required to determine the current vulnerability resulting from the environmental liability because this disclosure is required in all financial statements.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

1. An auditor should keep in mind the current tax laws and regulations when performing an audit of a benefit plan. If noncompliance with the tax laws has an indirect effect on the financial statements of the plan, what is the auditor’s responsibility? (Page 251)

a. The auditor does not have an obligation when the noncompliance has an indirect effect on the financial statements. [This answer is incorrect. According to authoritative literature, the auditor does have an obligation, in this instance, and should consider the plan’s compliance when planning and performing the audit of the plan.]

b. The auditor should be knowledgeable of tax laws and regulations and be aware of any possible violations. [This answer is correct. SAS No. 54 (AU 317) indicates that for laws and regulations that have an indirect effect on the financial statements of the benefit plan, the auditor has a responsibility to be aware of possible violations.]

c. The auditor should plan the audit to give reasonable assurance of detecting violations. [This answer is incorrect. According to SAS No. 54 and SAS No. 99, the auditor should provide reasonable assurance of detecting violations when the violations have a direct and material effect on the financial statements, not an indirect effect.]

d. The audit should provide a high level of assurance that the plan complies with tax laws and regulations. [This answer is incorrect. The primary objective of a benefit plan audit is to provide reasonable assurance that the commitments and contingencies of the benefit plan are assessed and disclosed in the financial statements, rather than compliance with tax laws and regulations.]

2. Stephen is auditing the benefit plan of Tile Tools, Inc. He has discovered some violations of tax laws in his audit of the plan and has reported them to the plan management. Management is working with the IRS to correct the violations and prevent future violations. How should Stephen reflect this information in the plan’s financial statements, and/or the auditor’s report? (Page 251)

a. Stephen will need to modify his auditor’s report to disclose the situation. [This answer is incorrect. If the violations are severe and plan management is not actively trying to make appropriate corrections, then Stephen would need to modify his auditor’s report of the benefit plan. Management is working with the IRS to correct the violations in this instance.]

b. Stephen will issue an adverse opinion on the plan’s financial statements. [This answer is incorrect. If management is actively working with the IRS to correct the violations, then Stephen does not have to issue a qualified or adverse opinion on the plan’s financial statements. In this scenario, Tile Tool’s plan management is working toward resolution of the tax issues with the IRS.]

c. Since Tile Tool’s plan management is working with the IRS to fix the issues, Stephen does not have to address them in his report. [This answer is incorrect. Since Tile Tool’s plan management is working with the IRS for correction of the tax violations, it does allow Stephen more latitude in his auditor’s report, but he must address the issue, as required by audit procedures.]

d. Stephen should adequately disclose the violation in the financial statements. [This answer is correct. If plan management is working with the IRS to correct the violation and it does not appear that the IRS will disqualify the plan, then the auditor should adequately disclose the violation in the financial statements and possibly in an emphasis of a matter paragraph in the auditor’s report.]
3. Which of the following should an auditor include in a legal representation letter request to a company’s lawyer about the company’s benefit plan? (Page 253)

a. The letter should ask for all pending or threatened litigation, regardless of materiality. [This answer is incorrect. The auditor should state a materiality limit in the letter, so that the lawyer knows what items are to be considered material, individually or in the aggregate, so that they can tailor their response. The auditor should determine the materiality level based on some fraction of tolerable misstatement computed in audit planning.]

b. The auditor should stress in the letter to the lawyer that all communication should be in writing, so that the auditor can have it for their files. [This answer is incorrect. Response from the lawyer can be oral or written, there is no requirement that communication has to be written. Especially with volatile litigation proceedings, the auditor may decide to confirm a lawyer’s response very near to the date of the auditor’s report and there might not be time for written communication.]

c. The letter should ask for the likelihood of an unfavorable outcome on all pending litigation and an estimate of the amount of potential loss. [This answer is correct. The legal letter asks the lawyer to provide or corroborate information about pending or threatened litigation, including its nature and progress to date, how the plan is responding or intends to respond, the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the amount or range of potential loss. This allows the auditor to evaluate the disclosures that need to be made in the financial statements of the plan.]

d. An auditor only needs to ask the lawyer for information on asserted claims against the company’s benefit plan. [This answer is incorrect. The auditor should also request the lawyer to comment on any unasserted claims specifically identified by management and to confirm that he will notify management of any unasserted claims that come to the lawyer’s attention that, in the lawyer’s judgment, must be disclosed in accordance with the requirements of FASB ASC 450.]

4. Stephanie is auditing the benefit plan of Trade World, Inc. The company has a small benefit plan and does not retain inside legal counsel to help with its management. Stephanie is preparing a legal representation letter to send to the company’s lawyer. Which form should Stephanie prepare to send? (Page 254)

a. “Long form” request for legal representation. [This answer is incorrect. In the “long form” request for legal representation, the lawyer is asked to comment on the completeness of client-prepared information about the details of each matter listed as pending or threatened litigation. The “long form” approach may be more efficient if the plan has both inside and outside legal counsel, since the inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining outside counsel’s representations.]

b. “Short form” request for legal representation. [This answer is correct. In the “short form” request for legal representation, the lawyer is asked to prepare the information rather than just comment on management’s list of pending or threatened litigation. This form is usually best suited for a small plan, especially if the plan does not have inside counsel.]

5. If an employee benefit plan has an investment that could cause an environmental liability, how are the audit procedures modified by the auditor? (Page 255)

a. An environmental specialist may be needed for the auditor to create an expectation of the estimate of the environmental liability. [This answer is correct. When an auditor is developing an independent expectation of the estimate of potential liability, the use of an environmental specialist might be needed to confirm that the estimate is correct.]

b. The auditor is usually informed of potential environmental liabilities by notification from a federal regulator. [This answer is incorrect. The most common way an auditor is informed of potential environmental liabilities is from the lawyer’s response on the representation letter.]
c. The audit procedures for environmental liabilities are vastly different than those for contingent liabilities since there are so many laws governing the environment. [This answer is incorrect. The audit procedures for environmental liabilities generally are the same procedures applied for other contingent liabilities (for example, reading the minutes of board or administrative committee meetings, making inquiries of the client’s attorney, and making inquiries of the client).]

d. Additional audit procedures will not be required to determine the current vulnerability resulting from the environmental liability because this disclosure is required in all financial statements. [This answer is incorrect. FASB ASC 275 requires disclosures about risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. Current vulnerability resulting from certain concentrations in environmental liabilities is one of those areas. In this area, specific procedures may be necessary to determine that all disclosures have been identified because this is not one of the areas in which disclosures are normally required in financial statements.]
SUBSEQUENT EVENTS REVIEW

FASB ASC 855-10, Subsequent Events (formerly SFAS No. 165, Subsequent Events) includes accounting and disclosure standards on subsequent events. That guidance was previously contained in the SASs at AU 560. The AICPA Technical Practice Aid, Effect of FASB ASC 855 on Accounting Guidance in AU Section 560 (TIS 8700.01), clarifies that the accounting guidance in AU 560 is no longer applicable for auditors of nongovernmental entities.

FASB ASC 855-10-20 defines subsequent events as “events or transactions that occur after the statement of net assets date but before the financial statements are issued or available to be issued.” The period within this time is called the subsequent events period. The FASB renames type one subsequent events as recognition subsequent events and type two as nonrecognition subsequent events, but the guidance on identifying the two types of subsequent events remains essentially the same.

FASB ASC 855-10-50-1 (formerly Paragraph 12 of SFAS No. 165) requires reporting entities to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. That disclosure is required regardless of whether the reporting entity recognizes or discloses a subsequent event in its financial statements. The authors believe that, generally, nonpublic employee benefit plans will evaluate subsequent events through the date that the financial statements are available to be issued (FASB ASC 855-10-25).

SAS No. 1 (AU 560), Subsequent Events, defines the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events.

The auditor’s report is dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. This includes evidence about subsequent events, so the auditor’s report date cannot be earlier than the date of management’s subsequent events evaluation note. The AICPA Technical Practice Aid, Auditor Responsibilities for Subsequent Events, (TIS 8700.02) notes that in most cases the date of management’s subsequent events evaluation note will be the same date as the auditor’s report. Furthermore, management is required to make specific representations relating to information concerning subsequent events, and the date of the management representation letter should be the same as the date of the auditor’s report. Therefore, the subsequent evaluation note date, the management representation letter date, and the auditor’s report date generally will be the same.

Auditors should be mindful that subsequent events procedures need to be performed up through the date when the auditor has obtained sufficient evidence to support the opinion on the financial statements. In other words, if the auditor wraps up fieldwork, but cannot date his or her report because additional procedures must be performed, such as preparing financial statements or finalizing the review of the audit documentation, then subsequent events procedures should continue to be applied until the auditor is ready to date the report. In addition, it is ordinarily expected that the date of the auditor’s report will be close to the report release date. However, if there are delays in releasing the report, auditors should consider the need to reperform subsequent events review procedures through the date of the report.

The following events, when they occur after the financial statement date, are examples of common nonrecognition subsequent events for an employee benefit plan:

- Abnormal investment purchases or disposals since the plan year end.
- Amendments to plan provisions, trust agreements, and contracts with insurance companies.
- Unusual terminations of plan participants, such as those resulting from layoffs or a sale of a division.
- Changes in plan commitments or contingent liabilities.
- Any review or inquiry by the DOL, IRS, or other regulatory agency of the plan’s activities or filings, arising, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption.
• A decision made after the plan year end to terminate the plan. According to AEBP, Paragraph 2.69, a decision to terminate a plan made after the plan year end but before the financial statements are issued is a type two nonrecognition subsequent event requiring only disclosure in the notes to the financial statements.

• Mergers or spin-offs of plan assets.

• Plan sponsor experiences adverse financial conditions.

Some subsequent events may be discovered as a result of audit procedures applied for specific account balances or transaction classes. Other procedures are performed specifically to search for material subsequent events. They include reading minutes of meetings held through the date of the auditor’s report; scanning cash receipts and disbursements for the subsequent period; reading any interim financial statements, financial reports, or plan amendments prepared in the subsequent period and investigating any unusual fluctuations; and inquiring of management about the existence of significant subsequent events. The lawyer’s response and the management representation letter may also provide evidence of, or representations about, the existence of significant subsequent events. The auditor would apply any additional audit procedures necessary to follow up on material subsequent events identified.

Material Depreciation in Fair Value of Investments

Plan administrators and plan auditors should be reminded that plan investments are subject to appreciation and depreciation in fair value. The auditor should consider the market’s performance subsequent to year end to determine if there may have been material declines in the value of the plan’s investments and if so, whether disclosure is considered necessary. A reading of the plan’s interim financial statements may also highlight any significant depreciation in fair value. If present, those declines may impact other areas of plan operations, such as the funding levels of defined benefit plans and participant loans that previously had not exceeded 50% of the participant’s vested account balance but may now exceed that amount.

Timing

The subsequent events review procedures should cover a period as close as possible to the date of the audit report. The lawyer’s letter should have an effective date within about two weeks of the report date. The management representation letter and the subsequent events evaluation note should also generally be dated as of the audit report date.

RELATED PARTIES, PARTIES IN INTEREST, AND PROHIBITED TRANSACTIONS

Related-party considerations are extremely important in an employee benefit plan audit because ERISA designates certain related parties and others as “parties in interest” and prohibits certain transactions between the plan and such parties. The auditor is required to report on Schedule G of Form 5500 that discloses all such nonexempt prohibited transactions (whether material or not) of which he or she becomes aware during the audit. This requirement is in addition to the normal GAAP requirement for financial statement disclosure of material related-party transactions. The DOL is very concerned about adequate disclosure of prohibited transactions with parties in interest.

Definitions

The glossary of FASB ASC 850 (formerly SFAS No. 57, Related Party Disclosures), defines a related party and ERISA defines a party in interest. The definition of a party in interest is similar to the definition of a related party, but it is broader. Exhibit 1-1 compares the glossary definition of a related party (as adapted for relevance to an employee benefit plan) and the ERISA definition of a party in interest. (Note that the IRC uses the term “disqualified person” with substantially the same meaning as “party in interest.”)
FASB ASC 850 (formerly SFAS No. 57) gives examples of related-party transactions, and ERISA specifies transactions between the plan and a party in interest that are prohibited. Exhibit 1-2 compares related-party transactions and prohibited transactions. (Note that the terms prohibited transaction, nonexempt party-in-interest transaction, and prohibited party-in-interest transaction are used interchangeably.)

**Exhibit 1-1**

**Definitions of Related Party and Party in Interest**

**Related Party (FASB ASC 850)**

*The plan sponsor or employers participating in a multiemployer plan.* A related party to an enterprise includes trusts for the benefit of employees, such as pension or profit-sharing trusts that are managed by or under the trusteeship of management. The “trust” includes the plan, as well as the trust that holds the plan’s assets. They also believe that if the trust (or plan) is a related party to the plan sponsor, then the plan sponsor (or employer participating in a multiemployer plan) is a related party to the plan.

*Principal owners of the enterprise and their immediate families.* With respect to an employee benefit plan, this definition would include principal owners of the enterprise sponsoring a single-employer plan or of the companies participating in a multiemployer plan.

*Management of the plan and their immediate families.* Management is defined as “normally including” members of the plan’s board of trustees or administrative committee, the chief operating and executive officers (which would be the plan administrator), and “others who are responsible for achieving the objectives of the [plan] and have the authority to establish policies and make decisions by which those objectives are to be pursued.”

**Party in Interest (ERISA)**

*The employer (or his relative) whose employees are covered by the plan.* This definition refers to the plan sponsor or employers participating in a multiemployer plan.

*A direct or indirect owner (or his relative) of 50% or more of (1) the combined voting power or the total value of all shares of a corporation that is an employer or employee organization whose employees/members are covered by the plan, (2) the capital or profits interest of a partnership that is an employer or employee organization whose employees/members are covered by the plan, or (3) the beneficial interest of a trust or unincorporated enterprise that is an employer or employee organization whose employees/members are covered by the plan.*

*An employee, officer, director, or other person with similar authority to an officer’s or director’s of an employer or owner of an employer entity. Also, one who is deemed to be a fiduciary because he or she exercises discretionary authority or control over the management or administration of the plan. These persons would include the plan administrator. (As described below, a fiduciary includes other persons as well.)*

*One who is a fiduciary because he or she has control over the disposition of plan assets, for example, an investment trustee with discretionary authority. Also, one who is a fiduciary because he or she gives investment advice for a fee or compensation, or has authority to do so, for example, an investment advisor.*
Related Party (FASB ASC 850)  
(formerly SFAS No. 57)

A person (or his relative) who provides services to the plan. This definition would include the plan actuary, investment custodian, auditor, lawyer, etc.

An employee organization whose members are covered by the plan.

* * *

Exhibit 1-2  
Related-party and Prohibited Transactions

Related-party Transactions  
(FASB ASC 850) (formerly SFAS No. 57)

Sales, purchases, and transfers of realty and personal property between a plan and a related party.

Services received, for example, accounting, management, and legal services. Also, use of property and equipment by lease or otherwise. GAAP specifically includes related-party transactions that are not given accounting recognition, such as when a plan receives services from the plan sponsor without charge and does not record their receipt.

Borrowings and lendings, guarantees, and maintenance of bank balances for a related party’s benefit.

Prohibited Transactions  
(ERISA)

Sale, exchange, or leasing of property between a plan and a party in interest. Also, the transfer of plan assets to, or for the use or benefit of, a party in interest.

Furnishing of goods, services, or facilities between the plan and a party in interest. However, parties in interest may provide necessary operating facilities and services to the plan and receive reasonable compensation for them.

Lending of money or extension of credit between the plan and a party in interest, which includes failing to remit employee contributions to the plan on a timely basis. However, plans may make loans available to plan participants, and ESOPs may borrow from a party in interest if certain requirements are met.

Acquisition of qualifying employer securities or qualifying employer real property, as defined, exceeding, at the time of acquisition, 10% of the fair value of plan assets. (This limit does not apply to ESOPs, thrift or savings plans, stock bonus plans, profit sharing plans, and some money purchase plans.)

A fiduciary may not deal with plan assets for his or her own account or for his or her own interest. He or she also may not receive any personal consideration from anyone in a transaction involving plan income or assets. However, a fiduciary may receive reasonable compensation or expense reimbursement for services provided to the plan and may receive any benefit to which he or she is entitled as a plan participant, as long as it is consistent with that computed and paid to other plan participants.

* * *
Detection Responsibility

The auditor’s detection responsibility for related-party transactions and party-in-interest transactions is the same. As required by SAS No. 45 (AU 334.04), the auditor must be aware during the audit of the possibility of material related-party transactions. AEBP, Paragraph 11.08, states that the auditor “should be aware of the possible existence of party in interest and material related-party transactions that could affect the financial statements” or are required to be disclosed. Note that AEBP does not limit the auditor’s awareness responsibility to material party-in-interest transactions. That is because ERISA requires all nonexempt prohibited party-in-interest transactions of which the auditor is aware, whether material or not, to be disclosed in the Schedule G to Form 5500, whereas GAAP requires financial statement disclosure only of material related-party transactions.

Audit Procedures

Audit procedures for related parties and parties in interest are applied at all audit stages. At the start of the audit, the auditor should determine the plan administrator’s system for identifying parties in interest and detecting prohibited transactions. Additional procedures include identifying obvious or known related parties and parties in interest and transactions (or updating information obtained in previous audits) and communicating that information to the audit staff to consider as other procedures are applied during the audit. Inquiry of predecessor auditors and plan management; review of prior audit workpapers, minutes, contracts, and agreements; etc., are sources of information about related parties, parties in interest, and transactions with such parties. In an employee benefit plan audit, the auditor may also review documents filed with the IRS, DOL, or other regulatory agencies for information.

When examining transactions in the audit of specific accounts or in the subsequent events review, the auditor should consider whether the transactions involve related parties or parties in interest. Generally, the same audit procedures are applied to related-party and party-in-interest transactions that are applied to other transactions. Procedures include vouching, examining authorizations, confirmation, recomputation, etc., to obtain an understanding of the transaction’s nature, extent, and business purpose and to obtain reasonable assurance that the transactions do not contain misstatements that could be material to the financial statements.

To obtain an understanding of a transaction’s nature or purpose, it may be necessary to apply additional procedures. Examples of such procedures include inspecting evidence possessed by the other party to the transaction; discussing relevant information with intermediaries, such as banks, agents, or attorneys; referring to financial publications, credit agencies, and other sources for information about unfamiliar parties to the transaction; etc. The auditor should consider whether any related-party or party-in-interest transactions are occurring that are not being recognized in the accounting records. An important consideration is whether any related-party or party-in-interest transactions identified (whether recorded or not) are prohibited transactions.

A plan might pay fees or expenses to a related party or on behalf of a related party. The Employee Benefit Plans Industry Developments—2009 (Audit Risk Alert) cautions the auditor to be alert for such transactions as follows:

Auditors may also want to be aware of fees paid by one plan on behalf of another plan resulting from errors or inappropriate allocations or fees paid by the plan for certain services (actuarial fees) that may relate to services provided to the plan sponsor. Excessive fees or expenses paid by the plan that are not allowed by the plan document, no matter how immaterial, may be deemed a prohibited transaction requiring further testing and disclosure as described in paragraph 11.13 of [AEBP].

If the auditor believes a transaction may be a prohibited transaction, he or she should follow the guidance in SAS No. 54 (AU 317), Illegal Acts by Clients. Such guidance relates to consulting with the client and legal counsel about the matter, considering the implications for other aspects of the audit, and considering the possible effects on the financial statements and auditor’s report.

Related Party Transactions and Fraud. SAS No. 99 (AU 316), Consideration of Fraud in a Financial Statement Audit, requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements (for example, selling real estate or other assets to a related party for artificial gain).
Disclosures

Related Parties. GAAP requires certain note disclosures about related parties. Note that disclosure of the fact that the plan sponsor or participating employers are absorbing significant administrative costs, if that is the case, is specifically required.

Prohibited Transactions. A prohibited transaction may give rise to a significant receivable because the fiduciary is liable to the plan for any losses the plan sustained, or profits the fiduciary gained, as a result of the breach of fiduciary duty. Thus, the auditor should consider the disclosure requirements of FASB ASC 450 (formerly SFAS No. 5, Accounting for Contingencies). If the auditor also audits the sponsor’s financial statements, these matters may also be material to the sponsor’s financial statements. Also, since a prohibited transaction is an illegal act, the normal SAS No. 54 procedures and disclosures should be considered. As previously mentioned, all identified nonexempt prohibited transactions, whether material or not, must be reported on the Schedule G to Form 5500. This schedule is in addition to the normal GAAP note disclosures for related parties.

GOING CONCERN CONSIDERATIONS

Applicability of SAS No. 59

AEBP, Paragraph 5.126, discusses the application of SAS No. 59 (AU 341), The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern, as amended, to employee benefit plans and states the following:

For financial reporting purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the plan’s ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of [operations], externally forced revision of its operations, or similar actions.

For an employee benefit plan, the most significant obligation is, of course, benefit obligations. Ability to meet benefit obligations is more crucial for a defined benefit plan than for a defined contribution plan. The reason is that a defined benefit plan’s benefit obligations are not limited to its net assets available for benefits, as is the case for a defined contribution plan.

Applicability of SAS No. 59 to Terminating Plans. An employee benefit plan may terminate. SAS No. 59 (AU 341) does not apply if a decision to terminate is made before the plan year end. The reason is the financial statements must be prepared on the liquidation basis of accounting. Footnotes 1 and 2 to Paragraph 1 of SAS No. 59, as amended, (AU 341.01) specifically state that the SAS does not apply to an audit of financial statements based on the assumption of liquidation or prepared on the liquidation basis of accounting.

If a decision to terminate is made after the plan year end, but before the financial statements are issued, the liquidation basis of accounting is not used, but the decision is disclosed as a subsequent event and the disclosure requirements of SAS No. 59, as amended, apply. An explanatory paragraph should be added to the auditor’s report whenever there is an intention to terminate the plan after the financial statement date.

Conditions and Events

SAS No. 59, as amended, requires the auditor to evaluate whether conditions and events identified during the audit, when considered in the aggregate, indicate that there could be a substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time, that is, for a period not to exceed one year beyond the financial statement date. Examples of such conditions or events particularly relevant to an employee benefit plan include:

- Need to obtain an extraordinary contribution from the plan sponsor.
- Need to dispose of substantial assets outside the ordinary course of operations.
• Inability to make benefit payments when due.
• Default on loan or similar agreements.
• Restructuring of debt.
• Legal proceedings, legislation, or similar matters, for example, determination that the plan is no longer a qualified plan, that might jeopardize a plan’s ability to operate.
• The plan’s merger or consolidation with another plan or its transfer of assets or liabilities to another plan.
• The plan’s adoption of an amendment that reduces the benefit payable from employer contributions.
• Failure to meet the minimum funding requirements; or the request for, or granting of, a minimum funding waiver.
• The bankruptcy, insolvency, liquidation, dissolution, or similar settlement of the plan sponsor or of employers participating in a multiemployer plan.
• The PBGC’s determination that the plan sponsor will be unable to meet its debts and continue in business without a termination of the plan, or that continued pension costs are unreasonably burdensome because of a decline in the workforce covered by the plan.
• The filing of notices to the PBGC that the plan intends to seek a distress termination.
• The plan administrator’s reporting of a reportable event to the PBGC. (Reportable events include some of the preceding matters.)

Some of these conditions and events pertain to the plan sponsor. During the audit, the auditor may become aware that the plan sponsor may not be able to continue as a going concern. AEBP, Paragraph 5.126, states “although employee benefit plans are not automatically and necessarily affected by the plan sponsor’s financial adversities, this situation may result in the auditor determining it to be a condition or event sufficient to evaluate whether there is substantial doubt about the plan’s ability to continue as a going concern.”

Audit Procedures

SAS No. 59 does not mandate any procedures specifically and solely to search for conditions or events that might indicate inability to continue as a going concern, but it does require a specific assessment of whether audit procedures that were applied for other purposes identified such conditions and events. Such other auditing procedures include applying analytical procedures, reviewing subsequent events, reading minutes, inquiring of the plan’s legal counsel about litigation, claims, and assessments, etc.

If necessary, the auditor should apply procedures to obtain additional information about any conditions and events identified. If, after considering the identified conditions and events, the auditor believes there is a substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time, he or she should obtain information about management’s plans that are intended to mitigate the effect of the conditions and events and assess the likelihood that those plans can be effectively implemented. The auditor may have to consider the plan sponsor’s plans for dealing with its financial difficulties if he or she believes those difficulties may adversely affect the plan’s ability to continue as a going concern.

If the preceding procedures cause the auditor to conclude that there is substantial doubt about the plan’s ability to continue as a going concern, the auditor should consider the possible effects on the financial statements, adequacy of disclosures, and auditor’s report. Certain disclosures may be necessary, even if the auditor’s initial substantial doubt is alleviated based on his consideration of management’s plans. The auditor also has an obligation to communicate certain matters to those charged with governance. Also, AEBP, Paragraph 5.127, states that if a plan sponsor intends to terminate the plan within 12 months of the financial statement date, the auditor should disclose that fact in an explanatory paragraph of the auditor’s report, regardless of the auditor’s assessment.
of asset recoverability and liabilities amount and classification. The authors interpret this statement as requiring an explanatory paragraph whenever termination is intended.

**Documentation Requirements**

When conditions or events cause the auditor to believe there is substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time, SAS No. 59 (AU 341.17), as amended, requires documentation of the following:

- Conditions or events causing the auditor to believe there is substantial doubt about the plan’s ability to continue as a going concern.

- The elements of management’s plans most significant to overcoming the adverse effects of the conditions or events.

- The auditing procedures performed and evidence obtained to evaluate those significant elements.

- The auditor’s conclusion about whether substantial doubt remains or is alleviated and the possible effects on the financial statements and related disclosures.

- The possible effects on the auditor’s report, including the auditor’s conclusion about whether an explanatory paragraph is necessary and whether to modify the auditor’s report for inadequate disclosures.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Jane has completed audit procedures on the financial statements of StackHouse Parts' benefit plan. She is now working on her subsequent events review and discovers that plan management has changed the plan commitments for the benefit plan in the coming year. This is important information that affects the audit of the plan in the future, however it does not affect the financial statements for the current year and Jane decides that the information should be disclosed in the notes to the financial statements. Which type of subsequent event has Jane identified?
   a. A nonrecognized subsequent event.
   b. A recognized subsequent event.

7. John is completing an audit of a public company's benefit plan. He completed the audit of the financial statements on July 1, completed his subsequent events review procedures on July 15, and issued the auditor's report on September 15. The company's lawyer has provided his legal representation letter with a date of September 28 and management provided their representation letter dated September 20. Which of these dates did John complete within the guidelines provided by the auditing standards?
   a. The management of the company supplied their representation letter to John with the correct date.
   b. John evaluated the subsequent events for an appropriate amount of time.
   c. The lawyer provided the legal representation letter within an appropriate time period.
   d. The subsequent events review procedures were completed for the prescribed amount of time.

8. Which of the following people would be considered a related party for the benefit plan of Snapshot Ventures, as defined by FASB ASC 850?
   a. The CEO of Snapshot Ventures.
   b. An investor that owns 60% of the partnership of Snapshot Ventures.
   c. The actuary of the benefit plan for Snapshot Ventures.
   d. The investment trustee of the benefit plan of Snapshot Ventures.

9. What is the GAAP requirement for related party transactions in financial statements?
   a. The disclosure requirement is the same for both related-party and party in interest transactions.
   b. Only transactions that are material to the financial statements require disclosure.
   c. All related-party transactions of which the auditor is aware, whether material or not, should be disclosed.

10. Stacy is auditing the benefit plan of Red Door Transactions and locates a nonexempt prohibited transaction between related parties. Stacy's firm also performs the audit of Red Door's sponsor, Red House Foundation. Which of the following is true regarding the disclosure requirements for the prohibited transaction?
    a. The transaction must be reported only if it is material to the financial statements.
    b. If the prohibited transaction is disclosed in Red Door's financial statements, it should not affect Red House Foundation.
    c. A significant receivable might accrue due to the prohibited transaction and should be disclosed.
    d. Administrative costs accounted for by Red House Transactions for Red Door do not have to be disclosed.
11. If the decision to terminate an employee benefit plan is made after the plan year has ended but before the financial statements are issued, which of the following is true?

a. The auditor’s report should contain an explanatory paragraph.

b. The financial statements must be prepared on the liquidation basis of accounting.

c. No disclosure is required in the financial statements.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

6. Jane has completed audit procedures on the financial statements of StackHouse Parts' benefit plan. She is now working on her subsequent events review and discovers that plan management has changed the plan commitments for the benefit plan in the coming year. This is important information that affects the audit of the plan in the future, however it does not affect the financial statements for the current year and Jane decides that the information should be disclosed in the notes to the financial statements. Which type of subsequent event has Jane identified? (Page 262)

   a. A nonrecognized subsequent event. [This answer is correct. According to the auditing standards, a transaction or event that occurs after the financial statement date that should be disclosed in the financial statements is defined as an nonrecognized subsequent event.]

   b. A recognized subsequent event. [This answer is incorrect. A recognized subsequent event is a transaction or event that occurred after the financial statement date that should be recorded in the financial statements.]

7. John is completing an audit of a public company's benefit plan. He completed the audit of the financial statements on July 1, completed his subsequent events review procedures on July 15, and issued the auditor's report on September 15. The company's lawyer has provided his legal representation letter with a date of September 28 and management provided their representation letter dated September 20. Which of these dates did John complete within the guidelines provided by the auditing standards? (Page 263)

   a. The management of the company supplied their representation letter to John with the correct date. [This answer is incorrect. The company's management provided the management representation letter as of September 20, but the audit report was dated September 15. The management representation letter should be dated as of the audit report date.]

   b. John evaluated the subsequent events for an appropriate amount of time. [This answer is incorrect. FASB ASC 855-10501 requires that public companies evaluate subsequent events until the audit report is issued. John did not review them for the entire time between the completion of the audit and the issuance of the audit report.]

   c. The lawyer provided the legal representation letter within an appropriate time period. [This answer is correct. The lawyer’s letter should have an effective date within about two weeks of the report date. The lawyer provided his letter within 13 days of the issuance of the auditor’s report.]

   d. The subsequent events review procedures were completed for the prescribed amount of time. [This answer is incorrect. The subsequent events review procedures should cover a period of time, ending as close as possible to the date of the audit report. John completed his subsequent events review procedures on July 15, but did not complete the auditor’s report until September 15.]

8. Which of the following people would be considered a related party for the benefit plan of Snapshot Ventures, as defined by FASB ASC 850? (Exhibit 1-1)

   a. The CEO of Snapshot Ventures. [This answer is correct. According to FASB ASC 850, the management of the plan is considered a related party. Management is defined as “normally including” members of the plan’s board of trustees or administrative committee, the chief operating and executive officers and “others who are responsible for achieving the objectives of the [plan] and have the authority to establish policies and make decisions by which those objectives are to be pursued.”]
b. An investor that owns 60% of the partnership of Snapshot Ventures. [This answer is incorrect. A direct or indirect owner of 50% or more of the capital or profits interest of a partnership that is an employer or employee organization whose employees/members are covered by the plan is deemed a party in interest by the ERISA.]

c. The actuary of the benefit plan for Snapshot Ventures. [This answer is incorrect. According to ERISA, a person who provides services to the plan, for example the actuary, would be considered a party in interest, not a related party.]

d. The investment trustee of the benefit plan of Snapshot Ventures. [This answer is incorrect. Per ERISA, a person who is a fiduciary because he or she has control over the disposition of plan assets, for example, an investment trustee with discretionary authority is a party in interest.]

9. What is the GAAP requirement for related-party transactions in financial statements? (Page 266)

a. The disclosure requirement is the same for both related-party and party in interest transactions. [This answer is incorrect. The AEBP requires that the auditor be aware of the possible existence of party in interest and material related-party transactions that could affect the financial statements or are required to be disclosed, but GAAP does not require this level of disclosure.]

b. Only transactions that are material to the financial statements require disclosure. [This answer is correct. GAAP requires financial statement disclosure only of material related-party transactions, not all related-party transactions.]

c. All related-party transactions of which the auditor is aware, whether material or not, should be disclosed. [This answer is incorrect. GAAP does not require this level of disclosure, but ERISA requires all nonexempt prohibited party-in-interest transactions of which the auditor is aware, whether material or not, to be disclosed in the Schedule G to Form 5500.]

10. Stacy is auditing the benefit plan of Red Door Transactions and locates a nonexempt prohibited transaction between related parties. Stacy’s firm also performs the audit of Red Door’s sponsor, Red House Foundation. Which of the following is true regarding the disclosure requirements for the prohibited transaction? (Page 267)

a. The transaction must be reported only if it is material to the financial statements. [This answer is incorrect. All identified nonexempt prohibited transactions, whether material or not, must be reported on the Schedule G of Form 5500.]

b. If the prohibited transaction is disclosed in Red Door’s financial statements, it should not affect Red House Foundation. [This answer is incorrect. Since Stacy’s firm also audits Red House Foundation’s financial statements and Red House is the sponsor of Red Door, then the prohibited transaction could be material and should be considered when completing Red House Foundation’s audit.]

c. A significant receivable might accrue due to the prohibited transaction and should be disclosed. [This answer is correct. A prohibited transaction may give rise to a significant receivable because the fiduciary is liable to the plan for any losses the plan sustained, or profits the fiduciary gained, as a result of the breach of fiduciary duty. Thus, Stacy should consider the disclosure requirements of FASB ASC 450, formerly SFAS No. 5, Accounting for Contingencies.]

d. Administrative costs accounted for by Red House Transactions for Red Door do not have to be disclosed. [This answer is incorrect. GAAP requires certain note disclosures about related parties. Disclosure of the fact that the plan sponsor is absorbing significant administrative costs of the plan is specifically required.]
11. If the decision to terminate an employee benefit plan is made after the plan year has ended but before the financial statements are issued, which of the following is true? (Page 267)

a. The auditor’s report should contain an explanatory paragraph. [This answer is correct. If a decision to terminate the plan is made after the plan year end, but before the financial statements are issued, the disclosure requirements of SAS No. 59 apply and an explanatory paragraph should be added to the auditor’s report.]

b. The financial statements must be prepared on the liquidation basis of accounting. [This answer is incorrect. If the decision to terminate the employee benefit plan is made after the plan year has ended but before the financial statements are issued, the liquidation basis of accounting is not used. But, if the decision is made before the plan year ends, then the liquidation basis of accounting is used.]

c. No disclosure is required in the financial statements. [This answer is incorrect. If the decision to terminate the employee benefit plan is made after the plan year has ended but before the financial statements are issued, the decision should be disclosed as a subsequent event in the financial statements and the disclosure requirements of SAS No. 59 are applicable.]
EXAMINATION FOR CPE CREDIT

Lesson 1 (EBPTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Whom should the auditor make inquiries of when determining if all contingencies and commitments have been disclosed in the benefit plan’s financial statements?
   a. The audit team who completed the audit of the company.
   b. The accounting staff of the company.
   c. The sponsor of the company’s plan.
   d. The human resource department of the company.

2. Benefit plans that contain tax law violations relevant to the employee benefit plan have a direct effect on the plan’s financial statements.
   a. True.
   b. False.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

3. How does an amendment to the plan for tax qualification affect the benefit plan audit?
   a. If the plan has been formally amended subsequent to the most recent determination letter, the auditor does not have to disclose the information in the notes to the financial statements.
   b. The auditor does not have to worry about how the amendment will affect the actual plan operations until the benefit plan has been formally amended.
   c. An auditor should be able to audit the plan’s tax status by looking at the formal plan document or the IRS determination letter.
   d. If the plan has not been formally amended, the auditor should get a representation letter from management explaining their intentions to formally amend the plan.

4. Which of the following is true regarding the legal representation letter?
   a. A lawyer’s statement in the response that stresses the retention of the attorney-client and attorney work privileges should not influence the auditor’s assessment.
   b. The dating of the letter is not important, as long as the lawyer includes the date in the response.
   c. The lawyer can limit the response to cases over a certain billable hours since that should encompass the bigger contingent liabilities.
   d. Wording such as “the plan believes there is absolutely no merit to the litigation” in the lawyer’s response will satisfy the auditor’s request.
5. How should an auditor determine if a significant estimate for environmental liabilities requires disclosure?
   a. If there is any possibility that the estimate will change by a material amount within one year of the financial statements.
   b. If the estimate was included in the preparation of the financial statements.
   c. If enough significant audit work was done to support the disclosure.
   d. If in-house legal counsel determines that the estimate is material to the company and reasonably possible.

6. What is the main difference between the auditing of concentrations and the auditing of significant estimates?
   a. The audit approach for determining concentrations is more involved than for significant estimates.
   b. The identification of significant estimates comes from the lawyer, but the identification of concentrations comes from the plan management.
   c. The disclosure for threshold for concentrations is severe impact, whereas the threshold for significant estimates is material.
   d. Formal documentation is required for concentrations. Significant estimates only require documentation in the relevant workpapers.

7. Which of the following would be considered a party in interest to a benefit plan, but not a related party?
   a. The employee of a company that has a benefit plan.
   b. The adult son of the owner of a company that provides a benefit plan to its employees.
   c. The president of one of the companies in a multi-employer benefit plan.
   d. The trustee of a trust that includes a multi-employer benefit plan.

8. Philip has recently started auditing benefit plans and is trying to distinguish if any of these transactions would be allowed. Which of the following would be considered a related party transaction under FASB ASC 850?
   a. The plan administrator borrowing money from the benefit plan.
   b. An actuary providing services to the benefit plan in exchange for an interest in the benefit plan.
   c. The president of a company purchasing a building from the benefit plan of his company.
   d. A plan sponsor provides legal services to the benefit plan, but does not record the transaction.

9. The audit procedures used for related party and party in interest transactions are different than procedures used to audit other transactions in an audit.
   a. True.
   b. False.
   c. Do not select this answer choice.
   d. Do not select this answer choice.
10. Which of the following is an audit procedure that an auditor would utilize in identifying conditions or events that might indicate an inability to continue as a going concern?

   a. Examining prior bank reconciliations for completeness.

   b. Reviewing the authorizations on documents.

   c. Employing analytical procedures.

   d. Tying back the revenue on financials to revenue reports.
Lesson 2: The Use of the Management Representation Letter, Workpapers and Risk Assessment on Concluding the Audit

INTRODUCTION

This lesson explains the requirements of the management representation letter, reevaluation of risk assessment and workpaper review at the conclusion of the audit, and the effect that the risk of material misstatement has on the procedures performed when concluding the audit.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the requirements of the management representation letter and how audit adjustments, and changes in management affect its issuance.
- Describe the procedures used at the conclusion of the audit to reevaluate the assessment of risk.
- Discuss the review of workpapers in concluding a benefit plan audit and how the evaluation of material misstatement affects the concluding audit procedures.

MANAGEMENT REPRESENTATION LETTER

SAS No. 85 (AU 333.01), Management Representations, requires the auditor to obtain written representations from client officials. A management representation letter, among other things, confirms oral representations about specific matters given to the auditor during the audit. The letter is part of the evidential matter the auditor obtains; however, it is not a substitute for other necessary audit procedures to corroborate information about matters for which written representations are obtained. SAS No. 85 is clear that management’s refusal to furnish written representations is a limitation on the audit scope sufficient to preclude an unqualified opinion.

Content of the Letter

In the representation letter, plan officials acknowledge their primary responsibility for the financial statements and provide other representations that are “ordinarily” obtained, according to SAS No. 85, for example, representations that all financial records were made available to the auditor. In addition to items specified in SAS No. 85, the letter should include any other matters relevant to employee benefit plans in general or to the specific engagement.

The management representation letter ordinarily should include the following matters specific to employee benefit plans, as applicable:

- Whether the plan instrument has been amended, including amendments to comply with applicable laws. This representation should include management’s intention to formally amend a plan that is operating in accordance with new administrative committee or board approved provisions adopted to comply with new laws or regulations but that has not been formally amended to reflect those provisions.
- Whether current versions of the plan and/or trust documents have been filed with the appropriate agency.
- Whether there were omissions from the participant data provided to the plan’s actuary for the purpose of determining amounts in the financial statements.
- Whether the appropriate person, normally the plan’s administrator, accepts the actuarial methods and assumptions used by the actuary for funding purposes and for determining accumulated plan benefits or benefit obligations and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances.
Whether there have been changes in (a) the actuarial methods or assumptions used in calculating amounts recorded or disclosed in the financial statements and (b) plan provisions between the actuarial valuation date and the date of the representation letter.

Whether the plan and the trust established under the plan are qualified under the appropriate section of the Internal Revenue Code and intend to continue as a qualified plan and trust.

Whether the plan has complied with the fidelity bonding requirements of ERISA.

Whether there were transactions with parties in interest that were not disclosed in Schedule G to Form 5500 or the financial statements.

Whether the plan has complied with the DOL’s regulation for remitting employee contributions to the plan on a timely basis.

Whether there were investments in default or considered to be uncollectible that were not disclosed in the supplemental schedules (Schedule G).

Whether there were reportable transactions that were not disclosed in the supplemental schedules.

Whether there is a present intention to terminate the plan.

There are no estimates subject to material change in the near term, or concentrations that make the plan vulnerable to risk of severe impact in the near term, other than those already disclosed, that are required to be disclosed.

An expansion of the representation about availability of all financial records to specifically include all plan amendments made to the plan, trust agreement, or insurance contracts during the year and all actuary’s reports prepared for the plan and the plan’s sponsor during the year.

Management’s identification of all material accounting estimates and their reasonableness.

The fair value of investments that do not have a readily determinable market price and thus were valued “in good faith” by the plan’s board of trustees, administrative or investment committee, or specialist engaged by the plan.

The representation discussed previously in lesson 1, if a lawyer was not consulted during the period.

Administrative expenses paid by the plan sponsor on behalf of the plan will not be reimbursed by the plan, if that is the case.

Compliance with the special tax and ERISA rules for top-heavy plans, if applicable.

No events occurred that would be reportable to the PBGC, if the plan is a defined benefit retirement plan.

Compliance of the form and content of the information included in the financial statements and schedules with the DOL reporting and disclosure rules.

In a DOL limited-scope audit, management’s representation that it instructed the auditor not to perform any auditing procedures with respect to information on investments prepared, and certified to, by the trustee, other than to compare the information with the related information in the financial statements and supplemental schedules.

If required communications are orally reported (as permitted in certain circumstances under SAS No. 114), it is desirable for management to acknowledge in the representation letter that the matters have been reported. Also, the letter may include management’s promise to let the auditor review any subsequently published document that includes the auditor’s report.
Modified Audit Reports. Some practitioners question the need to obtain a representation letter when the audit report disclaims an opinion. SAS No. 85 makes no exception in the event a disclaimer of opinion is issued. A representation letter should still be obtained.

Audit Adjustments

Known audit adjustments are normally recorded by employee benefit plans because of the DOL’s potential enforcement action against the plan for failing to properly calculate and maintain individual participant accounts. However, if the plan does not record one or more audit adjustments, SAS No. 85, as amended, requires an acknowledgment in the representation letter that plan management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are not material, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in, or attached to, the representation letter. SAS No. 85, as amended, does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), best practices indicate no representation about uncorrected misstatements is required in the management representation letter.

Uncorrected misstatements that should be communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor’s attention by the plan administrator. The summary of uncorrected misstatements also may include the current year effect of unadjusted audit differences from prior years (that is, the turnaround effect). Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences. Those misstatements need not be included in the summary of uncorrected misstatements communicated in the management representation letter.

The adjustments included in the summary may be aggregated. If the auditor chooses to aggregate the misstatements, they are normally aggregated by financial statement caption. If the adjustments are aggregated, they should be presented in sufficient detail to provide the plan administrator with an understanding of the nature, amount, and effect of the uncorrected misstatements.

Approaches for complying with requirements of SAS No. 85, as amended, are acceptable, such as summarizing the uncorrected misstatements within the body of management’s representation about uncorrected misstatements. However, this approach may entail a greater degree of summarization than would be presented in a separate schedule.

Materiality

SAS No. 85 (AU 333), as amended, permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. That limitation is acceptable, however, only for representations that directly relate to amounts included in the financial statements and only if the auditor and management reach an agreement about what is material for this purpose. It would not be acceptable, for example, to limit representations about the completeness of available financial records or about management’s responsibility for fair presentation. SAS No. 85, as amended, notes that materiality may be different for different representations, and it permits but does not require including an explicit discussion of materiality in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable.

Signatures and Date on the Letter

The representation letter is obtained from officials who are responsible for and knowledgeable about, directly or through others, the matters covered by the representations. According to AEBP, Paragraph 12.24, for an employee benefit plan, the appropriate persons from whom to obtain the letter normally are the plan’s administrator or other parties performing the plan’s management function. They would include the person equivalent to the plan’s chief financial or accounting officer. If the sponsoring employer of a single-employer plan is the plan administrator, the letter would be signed by the employer personnel who are responsible for plan administration and accounting. The letter should be dated as of the date of the auditor’s report. The auditor should coordinate the date of the management representation letter, subsequent events evaluation note, and audit report. Ideally, all three should bear the same date and the audit report date should be no earlier than the other two dates. AICPA Technical
Practice Aid, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report* (TIS 9100.06..07), clarifies that the requirement does not mean that the auditor needs to physically have management’s representation letter on the date of the auditor’s report. However, on or before the date of the auditor’s report plan management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter. The auditor will need to have the signed management representation letter prior to releasing the auditor’s report because management’s refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

**Periods Covered by the Letter**

SAS No. 85, as amended, (AU 333.10) also requires auditors to obtain written representations from current management on all periods covered in the auditor’s report. For example, if the auditor’s report covers the financial statements for the years ended 20X1 and 20X2, management’s representation letter should also cover both years. If management changed during or after the period under audit, the current management may be hesitant to provide this assurance. Auditors may point out that the letter limits the confirmant’s response to his or her best knowledge and belief. While, in some cases, it may be possible to obtain representations from the previous management, it is unlikely, and the auditor must obtain representations for all periods covered by the auditor’s report from current management. In some cases, certain officials of the plan’s management not present during the period under audit may decline because they are new to the situation. Best practices indicate that this is acceptable and would not result in a scope limitation. However, the auditor should make inquiries to determine that the reason for not signing the letter is because the official was not responsible for the financial statements and not due to other reasons (such as a disagreement about accounting matters or knowledge of an actual or suspected material misstatement). The official may be asked to sign a separate representation stating that he or she has no knowledge of a material matter that was not properly treated in the financial statements.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Which of the following is not accurate information to be included in the management representation letter?
   a. If a lawyer was not employed by the plan, management is not aware of any pending litigation against the benefit plan under audit.
   b. Management include any concerns about the viability of the entity’s plan.
   c. The plan administrator agrees to the methods and assumptions employed by the actuary for funding purposes of the benefit plan.
   d. Management attests that only investments that have a determinable market value were included in the benefit plan.

13. Audit adjustments are normally recorded by the plan due to potential enforcement action by the Department of Labor against the plan for failing to properly calculate and maintain individual participant accounts. Which of the following is a proper way for an auditor and management to deal with audit adjustments in a benefit plan?
   a. The uncorrected misstatements should be condensed in a document and attached to the financial statements.
   b. Management should document if there are no uncorrected misstatements.
   c. Audit adjustments identified by the auditor and the plan administrator may be combined and presented on a cumulative basis in the representation letter.
   d. Material uncorrected misstatements are not required to be incorporated in the financial statements, as long as the misstatements are addressed in the management representation letter.

14. Abby is conducting an audit of the benefit plan of Blue Water Incorporated that covers a two year period. There was a management change at Blue Water, Inc after the first year. Which of the following is correct regarding the management representation letter from Blue Water, Inc. for the benefit plan?
   a. The auditor should require a management representation letter that covers the entire time period of the audit.
   b. Previous management of Blue Water, Inc. should be contacted and required to submit a management representation letter for the time period of their responsibility.
   c. The auditor should accept the limitations of the management representation letter covering a specified time period since there was a management change and not verify other limitations.
   d. The auditor must have a signed management representation letter from Blue Water, Inc. before issuing the auditor’s report.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

12. Which of the following is not accurate information to be included in the management representation letter? (Page 281)

a. If a lawyer was not employed by the plan, management is not aware of any pending litigation against the benefit plan under audit. [This answer is incorrect. According to an auditing interpretation at AU 9337.15.17, the written representation obtained from plan management should state that management is not aware of any pending or threatened litigation, claims or assessments or unasserted claims or assessments and that a lawyer has not been consulted about such matters.]

b. Management include any concerns about the viability of the entity’s plan. [This answer is incorrect. According to SAS No. 85, management should indicate in the representation letter whether or not there is a present intention to terminate the plan.]

c. The plan administrator agrees to the methods and assumptions employed by the actuary for funding purposes of the benefit plan. [This answer is incorrect. The representation letter should include that the appropriate person, normally the plan’s administrator, accepts the actuarial methods and assumptions used by the actuary for funding purposes and for determining accumulated plan benefits or benefit obligations and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances as dictated by SAS No. 85.]

d. Management attests that only investments that have a determinable market value were included in the benefit plan. [This answer is correct. Management should include all investments in the benefit plan and should confirm in the management letter that investments that do not have a readily determinable market price were valued “in good faith” by the plan’s board of trustees, administrative or investment committee, or specialist engaged by the plan.]

13. Audit adjustments are normally recorded by the plan due to potential enforcement action by the Department of Labor against the plan for failing to properly calculate and maintain individual participant accounts. Which of the following is a proper way for an auditor and management to deal with audit adjustments in a benefit plan? (Page 283)

a. The uncorrected misstatements should be condensed in a document and attached to the financial statements. [This answer is incorrect. Per SAS No. 85, a summary of the uncorrected misstatements should be included in, or attached to, the management representation letter, not the financial statements.]

b. Management should document if there are no uncorrected misstatements. [This answer is incorrect. SAS No. 85, as amended does not provide specific guidance for the auditor when there are no uncorrected misstatements, but best practices indicate that no representation about uncorrected misstatements is required in the management representation letter.]

c. Audit adjustments identified by the auditor and the plan administrator may be combined and presented on a cumulative basis in the representation letter. [This answer is correct. Uncorrected misstatements that should be communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor’s attention by the plan administrator. The adjustments included in the summary of the representation letter may be aggregated according to SAS No. 85, but should be presented in sufficient detail to provide the plan administrator with an understanding of the nature, amount and effect of the uncorrected misstatements.]

d. Material uncorrected misstatements are not required to be incorporated in the financial statements, as long as the misstatements are addressed in the management representation letter. [This answer is incorrect. Material uncorrected misstatements must be recorded in the financial statements. SAS No. 85 only allows
uncorrected misstatements that are not material, both individually and in the aggregate, to the financial statements taken as a whole, to be acknowledged in the management representation letter, as opposed to the financial statements.]

14. Abby is conducting an audit of the benefit plan of Blue Water Incorporated that covers a two year period. There was a management change at Blue Water, Inc after the first year. Which of the following is correct regarding the management representation letter from Blue Water, Inc. for the benefit plan? (Page 284)

   a. The auditor should require a management representation letter that covers the entire time period of the audit. [This answer is correct. SAS No. 85, as amended, requires auditors to obtain written representation from current management on all periods covered in the auditor’s report. An auditor should explain to the current management that the letter limits the confirm ant’s response to his or her best knowledge and belief and should also try and contact previous management to satisfy this requirement.]

   b. Previous management of Blue Water, Inc. should be contacted and required to submit a management representation letter for the time period of their responsibility. [This answer is incorrect. While, in some cases, it may be possible to obtain representations from the previous management, it is unlikely, since previous management no longer has a vested interest in the plan.]

   c. The auditor should accept the limitations of the management representation letter covering a specified time period since there was a management change and not verify other limitations. [This answer is incorrect. If the management representation letter covers a shortened time period due to a change in management, then the auditor should make inquiries to determine that the reason is because the current management was not responsible for the financial statements for the entire period and not due to other reasons, such as disagreement about accounting matters or knowledge of an actual or suspected material misstatement.]

   d. The auditor must have a signed management representation letter from Blue Water, Inc. before issuing the auditor’s report. [This answer is incorrect. While the letter should be dated as of the date of the auditor’s report, AICPA Technical Practice Aid, The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report (TIS 9100.06-.07), clarifies that the requirement does not mean that the auditor needs to physically have management’s representation letter on the date of the auditor’s report. However, on or before the date of the auditor’s report, plan management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter.]
CONSIDERING THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

Reevaluating Risk Assessments

The auditor’s assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. In this situation, SAS No. 110 (AU 318.70) requires the auditor to reevaluate whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor’s risk assessments or result in the auditor performing additional audit procedures. Exhibit 2-1 (as adapted from paragraph 7.04 of the AICPA Audit Guide, Assessing and Responding to Audit Risk in a Financial Statement Audit) illustrates this concept.

Exhibit 2-1

Reevaluating the Initial Assessment of the Risk of Material Misstatement at the Relevant Assertion Level

When planning the audit of XYZ Company 401(k) Plan, the auditor initially assessed a low level of risk that the plan sponsor would not remit participant contributions to the plan in a timely manner. The auditor then determined the nature, timing, and extent of substantive procedures related to the accuracy or classification assertion based on her assessment of a relatively low risk of material misstatement.

While asking plan management whether participant contributions are remitted to the plan on a timely basis, the auditor discovered that the employee in the plan sponsor’s payroll department responsible for calculating and remitting participant contributions to the plan was on vacation during the payroll processing cycle one time during the year. Consequently, the sponsor deviated from its established process for remitting participant contributions to the plan and the remittance for one payroll cycle was two weeks late. As a result, the auditor (1) asked management to identify any other late remittances, and (2) reevaluated her initial risk assessment relating to accuracy or classification and increased the extent of tests of details over the transfer of participant contributions to the plan to obtain a higher level of assurance that all material misstatements relating to accuracy or classification errors had been identified.

* * *

As indicated in Exhibit 2-1, an auditor should not assume that an identified error or instance of fraud is an isolated occurrence. Instead, the auditor should consider how the misstatement affects the assessed risks of material misstatement. In doing so, the auditor should consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.

It is natural to have some deviations in the way controls are applied. Deviations may be caused by such factors as changes in key personnel, seasonal fluctuations in activity, and human error. As a result, controls may not operate as effectively as the auditor had expected. If the auditor detects deviations when performing tests of controls, he should determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures. The auditor should also consider whether misstatements identified when performing substantive procedures alter his judgment about the effectiveness of the related controls.

SAS No. 110 (AU 318.74) requires the auditor to evaluate whether audit risk has been reduced to an appropriately low level and whether the nature, timing, and extent of audit procedures may need to be reconsidered. At the end of the audit, the auditor concludes whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement. The sufficiency and appropriateness of audit evidence is a matter of the auditor’s professional judgment.
SAS No. 110 (AU 318.76) states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

**Evaluating the Existence of Fraud**

**Fraud Risk Assessment Is a Cumulative Process.** Assessing the risks of material misstatement due to fraud is a cumulative process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, or communicating with plan management or others. Examples of conditions the auditor may note that may change or support the assessment of fraud risks made during planning are included in Exhibit 2-2.

**Exhibit 2-2**

**Conditions That May Change or Support the Auditor’s Assessment of Fraud Risks**

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or plan policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the plan or plan sponsor at the last minute that substantially affect financial results.
- Evidence of employees’ unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.a
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by plan management to the auditor’s inquiries.
- Denial by plan personnel of auditor’s access to records, facilities, certain employees, actuaries, third-party administrators, or others.b
- Unusual discrepancies between confirmation replies and the plan’s records.
- Failure to retain documents or electronic files consistent with the plan’s record retention policies or practices.
- Unusual delays by plan personnel in providing requested information.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by plan management to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.
• Significant complaints from plan participants regarding the administration of the plan.

• Unfavorable results from recent IRS or DOL investigations.

Notes:

a If the auditor suspects that documents have been altered, it may be necessary to engage a specialist to determine their authenticity.

b Denial of access to information may constitute a limitation on the scope of the audit sufficient to preclude an unqualified opinion on the financial statements.

* * *

Required Procedures. SAS No. 99 (AU 316) requires auditors to evaluate whether the results of analytical procedures performed as substantive tests, or in the overall review stage of the audit, indicate a previously unidentified risk of material misstatement due to fraud. In addition, the SAS requires performance of analytical procedures relating to revenue, through the end of the reporting period. However, employee benefit plans do not have revenues. AEBP, Paragraph 5.100, indicates the risk of misstatement due to fraudulent financial reporting primarily relates to investment income arising from inappropriate investment valuation and to contributions being recognized inappropriately. If the full year’s information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit. Auditors also should consider, throughout the audit, whether responses to their inquiries about the results of analytical procedures have been vague, implausible, or inconsistent with other evidence.

At or near the date of the auditor’s report, SAS No. 99 requires the auditor to evaluate the accumulated results of audit procedures and other conditions noted during the audit to determine their effect on the auditor’s assessment of risks made previously. Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. In addition, the auditor with final responsibility for the audit should ascertain there has been adequate communication with the engagement team throughout the audit about information or conditions that indicate potential risks of material misstatement due to fraud. One way of doing this might be to hold another engagement team meeting.

Evaluating Significant Unusual Transactions

Additional substantive procedures that may be needed in particular circumstances depend on the auditor’s judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor’s risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit. One of those procedures involves evaluating significant unusual transactions.

SAS No. 99 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls (AU 316.66). The auditor should consider whether the business rationale (or lack thereof) suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business rationale for significant unusual transactions, the auditor should consider whether:

• The transaction is overly complex in relation to its stated purpose.

• Plan management is overly concerned that the transaction receives a particular accounting treatment.

• Previously unidentified related parties or parties in interest are involved in the transaction.
The parties to the transaction lack substance.

The transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by those charged with governance.

**Considering the Application of Significant Accounting Principles for Bias**

The auditor should consider whether the application of significant accounting principles indicates a bias on the part of plan management. In particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

**Documentation Requirements**

SAS No. 103 requires auditors to document significant audit findings or issues, actions taken and evidence obtained in addressing them, and the basis for the auditor’s conclusions. On some audits, the auditor may be faced with difficult issues that require significant professional judgment to resolve.

**ANALYTICAL PROCEDURES**

**Purpose of Analytical Procedures**

SAS No. 56 (AU 329), *Analytical Procedures*, as amended, requires the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides a sufficient understanding of such relationships identified during the planning or final review stages. The auditor assesses whether the financial statements make sense in light of the knowledge and understanding obtained during the audit. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, additional procedures may have to be applied.

Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the plan and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed. Although the objective of applying the procedures may differ, the analytical procedures actually applied may be very similar or identical. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment. Thus, in the final review, a simple comparison to prior period amounts at the financial statement level is normally effective.

One common form of documentation is referred to as a flux analysis. A flux analysis is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period. If a flux analysis is performed during preliminary planning and there are few adjustments, the flux analysis can be updated rather than reperformed in the final review. A flux analysis is not required by SAS No. 56 (AU 329), but it is a convenient means of documenting the thought process that is required by the SAS.

SAS No. 99 (AU 316) requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. As the financial statements of employee benefit plans do not report revenues, AEBP, Paragraph 5.100, indicates the risk of misstatement due to fraudulent financial reporting primarily relates to investment income arising from inappropriate investment valuation and to contributions being recognized inappropriately. Those procedures should be performed through the end of the reporting period. If the full year’s information is available during audit planning, the required procedures can be performed during preliminary analytical procedures. Otherwise, the analytical procedures related to contributions and investment income performed during planning should be updated during the final analytical review stage of the audit.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. During the planning of the audit, the auditor considers the risk of material misstatement and sets a relevant assertion level. SAS No. 110 governs how the auditor considers this assessment when concluding the audit. Which of the following is an accurate portrayal of the requirements of SAS No. 110?

a. The nature, timing and extent of audit procedures are set by the auditor in the planning stage of the audit per SAS No. 110.

b. SAS No. 110 compels the auditor to maintain the assessed level of risk decided upon in the planning stage of the audit.

c. The auditor should appraise the audit at its conclusion and determine if audit risk has been reduced to an appropriately low level.

d. If the auditor has not acquired adequate audit evidence to determine the material financial statement assertion by the end of the audit, a disclaimer of opinion should be issued.

16. In which of the following scenarios should the auditor contemplate modifying the assessment for fraud risk in the benefit plan audit?

a. Blue Collar Workforce has a benefit plan that Stephanie is auditing. There are numerous, significant reconciling items in the financials to the benefit plan. The plan administrator has been able to provide documentation for each item.

b. Libby is currently auditing the benefit plan of Cracker Jacker Snacks. During the audit, the record retention facilities of Cracker Jacker burned down, preventing Libby from inspecting personnel records. It has not been determined if the fire was accidental or intentionally set.

c. Grant is auditing the benefit plan of SKG Products. He is currently working with the plan administrator to clarify the disclosures in the financial statements because he does not feel they are comprehensible to the reader. The plan administrator is willing to make changes, but is struggling with the process.

d. Susie is completing the audit of the benefit plan of Organic Clothiers. A disgruntled, previous employee has lodged several complaints against the management and administration of the benefit plan. These are the only complaints against the management of the plan at this time.

17. When auditing for significant unusual transactions, which of these issues should the auditor deliberate?

a. Management continues to follow the expected accounting treatment for all benefit plan transactions.

b. Plan management uses the most straightforward accounting treatment for transactions in the benefit plan.

c. A transaction includes related parties that were not previously disclosed by plan management.

d. All parties included in a transaction seem appropriate for the benefit plan transaction.

18. Why does the auditor complete analytical procedures during the final review of the audit?

a. To acquire knowledge of the benefit plan and the financial statements.

b. To evaluate the risk of material misstatement in the plan financial statements.

c. To decide upon the procedures to execute in response to the risk assessment.

d. To ensure the competency of the procedures performed by the audit team.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

15. During the planning of the audit, the auditor considers the risk of material misstatement and sets a relevant assertion level. SAS No. 110 governs how the auditor considers this assessment when concluding the audit. Which of the following is an accurate portrayal of the requirements of SAS No. 110? (Page 288)

   a. The nature, timing and extent of audit procedures are set by the auditor in the planning stage of the audit per SAS No. 110. [This answer is incorrect. According to SAS No. 110, the nature, timing and extent of the audit procedures may need to be reconsidered at the conclusion of the audit.]

   b. SAS No. 110 compels the auditor to maintain the assessed level of risk decided upon in the planning stage of the audit. [This answer is incorrect. SAS No. 110 (AU 318.70) requires the auditor to reevaluate whether the assessment of risks of material misstatement at the relevant assertion level remain appropriate.]

   c. The auditor should appraise the audit at its conclusion and determine if audit risk has been reduced to an appropriately low level. [This answer is correct. SAS No. 110 (AU 318.74) requires the auditor to evaluate whether audit risk has been reduced to an appropriately low level at the conclusion of the audit.]

   d. If the auditor has not acquired adequate audit evidence to determine the material financial statement assertion by the end of the audit, a disclaimer of opinion should be issued. [This answer is incorrect. SAS No. 110 (AU 318.76) states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence.]

16. In which of the following scenarios should the auditor contemplate modifying the assessment for fraud risk in the benefit plan audit? (Exhibit 2-2)

   a. Blue Collar Workforce has a benefit plan that Stephanie is auditing. There are numerous, significant reconciling items in the financials to the benefit plan. The plan administrator has been able to provide documentation for each item. [This answer is incorrect. If there were significant unexplained reconciling items in the benefit plan financials, then Stephanie should consider changing the assessment for fraud risk, but since the plan administrator was able to provide documentation for each reconciling item, it would not hold as much concern for the auditor.]

   b. Libby is currently auditing the benefit plan of Cracker Jacker Snacks. During the audit, the record retention facilities of Cracker Jacker burned down, preventing Libby from inspecting personnel records. It has not been determined if the fire was accidental or intentionally set. [This answer is correct. Since the client has a failure to retain documents consistent with the plan’s record retention policy, whether intentionally or not, Libby needs to increase her assessment for fraud risk in relation to the audit of the benefit plan.]

   c. Grant is auditing the benefit plan of SKG Products. He is currently working with the plan administrator to clarify the disclosures in the financial statements because he does not feel they are comprehensible to the reader. The plan administrator is willing to make changes, but is struggling with the process. [This answer is incorrect. If the plan administrator was unwilling to make financial statement disclosures more clear or complete and thus, misleading the reader of the financial statements, then Grant would want to consider increasing the level of fraud risk for the engagement. But, since the plan administrator is willing to work with Grant on the changes, fraud risk does not necessarily need to be enhanced.]

   d. Susie is completing the audit of the benefit plan of Organic Clothiers. A disgruntled, previous employee has lodged several complaints against the management and administration of the benefit plan. These are the only complaints against the management of the plan at this time. [This answer is incorrect. If there were significant complaints from plan participants regarding the administration of the plan, then Susie should consider increasing the fraud risk in her assessment. Since there is only one account and it is a disgruntled, previous employee, the complaint would probably not hold as much weight.]
17. When auditing for significant unusual transactions, which of these issues should the auditor deliberate? (Page 290)

a. Management continues to follow the expected accounting treatment for all benefit plan transactions. [This answer is incorrect. An auditor should be concerned about significant unusual transactions when plan management is overly concerned that a transaction receives a particular accounting treatment.]

b. Plan management uses the most straightforward accounting treatment for transactions in the benefit plan. [This answer is incorrect. If plan management makes transactions overly complex in relation to its stated purpose, then it should raise a red flag to the audit team, but if plan management keeps its accounting treatment of transactions simplistic, then the auditor should not be heightened to significant unusual transactions.]

c. A transaction includes related parties that were not previously disclosed by plan management. [This answer is correct. If previously unidentified related parties or parties in interest are involved in a benefit plan transaction, then the auditor should consider the business rationale for this unusual significant transaction per SAS No. 99.]

d. All parties included in a transaction seem appropriate for the benefit plan transaction. [This answer is incorrect. If the parties to a benefit plan transaction seem to lack substance, then the auditor should be questioning unusual significant transactions.]

18. Why does the auditor complete analytical procedures during the final review of the audit? (Page 291)

a. To acquire knowledge of the benefit plan and the financial statements. [This answer is incorrect. Analytical procedures are applied to acquire knowledge of the benefit plan and the financial statements at the beginning of the audit, not during the conclusion. Since the auditors are working on completing the audit, they should already have a thorough knowledge of both the benefit plan and the financial statements of the benefit plan.]

b. To evaluate the risk of material misstatement in the plan financial statements. [This answer is incorrect. The risk of material misstatement needs to be addressed at the beginning of the audit in the planning stage so that the team can design the audit appropriately. The auditors can use the analytical procedures to help make the assessment.]

c. To decide upon the procedures to execute in response to the risk assessment. [This answer is incorrect. Analytical procedures can help the audit team determine the level of risk assessment, so they can construct an audit with procedures to discover any material misstatements. This step should be completed at the commencement of the audit, not at the conclusion.]

d. To ensure the competency of the procedures performed by the audit team. [This answer is correct. SAS No. 56 (AU 329), Analytical Procedures, requires the use of analytical procedures in the final review stage of the audit. The purpose of the analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides sufficient understanding of such relationships identified during the planning or final review stages.]
REVIEW OF WORKPAPERS

The review of workpapers near the conclusion of the engagement generally consists of a detailed review of the audit work of staff assistants and a higher level supervisory review. The supervisory review is usually conducted after financial statements and the auditor’s report have been drafted and is the final check on whether the audit work supports the overall conclusions on the financial statements.

Tax Department Review

In addition to the detailed and supervisory review by audit personnel, the CPA firm’s tax personnel may review tax aspects of the audit workpapers and financial statements, for example, those relating to plan qualification and unrelated business income, if the firm has such specialists. The auditor should be sure to discuss with tax department personnel any knowledge they may have of matters that may affect the financial statements.

Engagement Quality Control Review

Many firms require a review of the audited financial statements, auditor’s report, and other communications and reports by someone who has no other responsibility on the audit. SQCS No. 7, A Firm’s System of Quality Control, states that a firm should establish criteria against which all audit engagements should be evaluated to determine whether an engagement quality control review (EQCR) should be performed (QC 10.80). Firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. The following list represents the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as the DOL.
- Entities subject to governmental regulations, such as ERISA.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.
- Clients that have experienced material misstatements during the current or previous engagements.
- First-time clients.
- New firm partners.

If performed, that review should be completed before the audit report is released (QC 10.81). An engagement quality control review should be performed on each audit.

Timing of Review of Workpapers.

SAS No. 103 (AU 339), Audit Documentation, requires that the date of the auditor’s report should be no earlier than the date that sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that:

- The audit documentation has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The detailed and supervisory review should be performed and documented prior to the date of the auditor’s report.
Review Checklists

Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. A checklist should be employed on an employee benefit plan audit. The DOL has criticized employee benefit plan audit workpapers it reviewed that did not contain evidence of supervision or review by a partner or manager.

A thorough checklist has sections for documenting the detailed review, and engagement quality control review, partner review, and it includes an optional step relating to tax department review.

Common Peer Review Findings

Being aware of some of the recurring deficiencies found by the AICPA peer review program may assist in the detailed and supervisory review of the workpapers. The *Employee Benefit Plans Industry Developments—2008* (Audit Risk Alert) presents the following common recurring deficiencies noted in employee benefit plan audits:

- Inadequate testing of participant data.
- Inadequate testing of investments, particularly when held by outside parties.
- Inadequate documentation of audit procedures in areas such as payroll data, participant data, benefit payments, contributions, prohibited transactions, investment transactions, planning, understanding of internal control, and analytical procedures.
- 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, including the description of the method and significant assumptions used to determine fair value, an indication of how the fair value had been determined or the net change in fair value of each significant type of investment, the average yield, a description of the basis for determining the interest rate, and whether the contracts carry a minimum crediting interest rate.
- Failure to disclose the amount of forfeited nonvested accounts, party-in-interest transactions, or the reconciliation between the assets reported in the audited financial statements and the assets reported in the Form 5500.
- 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 related to ERISA and DOL.

The EBSA also conducts reviews of employee benefit plan audits.

**SUMMARIZATION AND EVALUATION**

One of the final steps near completion of the engagement is evaluation of the misstatements detected in fieldwork. SAS No. 99 (AU 316.75) requires that audit differences be evaluated as to whether they are indicative of possible
fraud. SAS No. 107 (AU 312.50) requires that the individual and combined effects of all uncorrected misstatements (both known and likely) be considered to determine whether they are material to the financial statements taken as a whole. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers.

**Categories for Evaluation**

The categories of misstatements and the format used to summarize them are matters of individual firm preference. The following classifications in this course are:

a. *Normal Closing Entries.* These are routine entries, such as adjustments of accruals, that are made to help the client close out the books for the year. If normal closing entries are booked, they are *not misstatements* and should not be included in the summary of audit differences. The normal closing entries ordinarily are not significant findings or issues that would be subject to the documentation requirements of SAS No. 103, *Audit Documentation.* Normally, the entries are prepared in each audit area as the fieldwork for a financial statement component is completed. However, it is often useful to group all those entries in one place. Grouping closing entries in one place is more convenient for supervisory review and discussion with the client. The client must agree with booking these entries and accept responsibility for them because the financial statements are the client’s responsibility.

b. *Audit Differences.* These are any differences noted between the accounting records and the evidence obtained during the audit, other than closing entries. An audit difference could be any of the following:

1. Passed adjustment for a specifically identified misstatement.
2. Projected misstatement from a substantive audit sampling application.
3. Significant unexplained difference from an analytical procedure that is treated like a misstatement.
4. Difference between the client’s accounting estimate and the relevant end of the auditor’s acceptable range for that estimate.

**Audit Differences**

In discussing summarization and evaluation, the term *audit differences* is used to refer to misstatements of amounts and classification. This term was adopted because, as a practical matter, the auditor can only summarize quantitative misstatements. Other misstatements, primarily those relating to presentation and disclosure assertions, are usually judged qualitatively on an individual basis.

**Known and Likely Misstatements.** In analyzing audit differences, a distinction is drawn between known and likely misstatements. These terms are defined in SAS No. 107 (AU 312.08) as follows:

a. *Known Misstatement.* A specific misstatement that the auditor identifies by performing audit procedures. A known misstatement arises from the incorrect selection or misapplication of accounting principles or misstatements of facts identified.

b. *Likely Misstatement.* Misstatements that (1) arise from differences between judgments made by management and the auditor about accounting estimates that the auditor believes are unreasonable or inappropriate, and (2) the auditor deems likely to exist resulting from an extrapolation from audit evidence obtained.

**Communication of Misstatements to Management.** SAS No. 107 (AU 312.42) requires the auditor to communicate to management on a timely basis all known and likely misstatements identified during the audit, other than trivial ones. SAS No. 107 (AU 312.44) requires the communication to distinguish between known and likely
misstatements. SAS No. 107 also requires the auditor to ask management to do the following with respect to misstatements the auditor has identified:

- Correct all known misstatements, other than trivial ones.
- Examine the account balance, transaction class, or disclosure in which the auditor identified a material likely misstatement from a sample to identify and correct misstatements in the account balance, transaction class, or disclosure.
- When the auditor has identified a likely misstatement involving a difference in an estimate, SAS No. 107 states that the auditor should ask management to review the assumptions and methods used in developing its (management’s) estimate. After management has reviewed and challenged the assumptions and methods, the auditor should reevaluate the amount of likely misstatement and, if necessary, perform further audit procedures.

If management decides not to correct some or all of the known or likely misstatements, the auditor should obtain an understanding of management’s reasons for not correcting the misstatements and take that into account when making the qualitative considerations discussed later in this course. The auditor should also consider the implications for the audit report. In addition, uncorrected misstatements are significant audit findings under SAS No. 114 and should be communicated to those charged with governance.

**Evaluating Audit Differences**

SAS No. 107 (AU 312.62) states that the auditor must evaluate whether the financial statements taken as a whole are free of material misstatement. SAS No. 107 (AU 312.50) requires that the individual and aggregate effects of all uncorrected misstatements (known and likely) be considered to evaluate whether the financial statements are fairly stated. In making that evaluation, the auditor should consider both quantitative and qualitative factors. The summarization and evaluation of audit differences can be complex. It should include consideration of the following factors:

- *Nature.* For example, contributions receivable not recorded.
- *Cause.* For example, arithmetic or mechanical mistake, or inappropriate application of an accounting principle because of misunderstanding.
- *Amount.* The dollar amount of the difference and whether the difference is an overstatement or understatement.
- *Effect.* The financial statement components affected by the difference.

According to SAS No. 107 (AU 312.51), misstatements should be combined in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, the misstatements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

**Trivial Misstatements.** Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences (often referred to as adjustments passed at the workpaper level). SAS No. 107 (AU 312.42) requires the auditor to accumulate all known and likely misstatements identified during the audit, except for those the auditor believes are trivial. Footnote 17 to AU 312.42 states that “trivial” matters “are amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.”

When determining whether the amount of a misstatement is below the amount that should be accumulated on the summary of audit differences, the auditor should be careful not to net proposed adjustments at the workpaper level. For example, assume the auditor has determined that only misstatements greater than $500 need to be accumulated on the summary of audit differences. If the auditor has a known misstatement that overstates net assets by
$10,000 and a likely misstatement that understates net assets by $10,500, both misstatements should be included on the summary of audit differences.

**Evaluating Estimates.** AEBP, Paragraph 5.125, identifies the following accounting estimates that are particularly relevant to employee benefit plans:

- Asset values for nonreadily marketable investments.
- The obligation for incurred but not reported benefit obligations (relevant to uninsured health and welfare benefit plans).
- The obligation for accumulated eligibility credits (relevant to some health and welfare benefit plans).
- Accrued experience-rating adjustments (relevant to some insured health and welfare benefit plans).
- Postretirement benefit obligation (relevant to health and welfare benefit plans).

An appendix to SAS No. 57 (AU 342) presents examples of other accounting estimates, of which the following are relevant to employee benefit plans:

- Uncollectible contributions and other receivables.
- Allowance for loan losses, for example, mortgages and participant loans.
- Actuarial assumptions.
- Useful lives, residual values, and depreciation and amortization methods related to operating property and equipment.
- Probability and amount of litigation losses.
- Valuation of securities.

SAS No. 57 highlights the importance of evaluating whether management has identified all material accounting estimates. The auditor should consider the circumstances of the client’s activities and any changes made or planned in its activities, operating strategy, or methods of accumulating information; new accounting pronouncements; identified litigation, claims, assessments, and other contingencies; and contents of regulatory or examination reports, supervisory correspondence, and similar materials from regulatory agencies. The SAS also recommends that the auditor inquire of management about whether there are circumstances that indicate the need for an accounting estimate.

SAS No. 57 does not prescribe the audit procedures that should be used to substantiate specific accounting estimates, but it does suggest a framework for designing audit procedures to evaluate the reasonableness of specific accounting estimates. An auditor may independently make an estimate for comparison with the client’s, may review and evaluate the client’s process of estimation for reasonableness, or may review subsequent events or transactions in identifying and evaluating estimates. Whatever approach is used, the usual result is a range for the estimate that the auditor considers reasonable. If the client’s estimate falls within this range, it is acceptable. If it falls outside the range, then the difference between the client’s estimate and the closest end of the auditor’s range should be considered a likely misstatement and summarized with other audit differences. SAS No. 107 (AU 312) states that an accounting estimate may be evaluated by comparing it with a range or a point estimate, if the point is a better estimate than any other amount. However, accounting estimates are usually evaluated based on a range of reasonableness because it is rarely possible to be precise in estimating future events.

SAS No. 107 also states that an auditor should consider whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of plan management. If plan management, for example, always chooses estimated amounts for the valuation of investments that are at the low end of the range the auditor
considers reasonable, the combined effect could result in a material misstatement of net assets. In that case, the auditor should consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates. The auditor should also consider whether plan management’s estimates were at one end of the auditor’s reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that plan management is using accounting estimates to manage net assets. If the auditor believes that is the case, he or she should consider communicating the matter to those charged with governance.

SAS No. 99 (AU 316) requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. In addition, it requires auditors to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. The review may provide additional information about whether the current year’s estimates could be biased. If the auditor identifies possible bias, the auditor should evaluate whether the circumstances represent a risk of material misstatement due to fraud.

**Different Levels for Different Amounts, Subtotals, or Totals.** For planning purposes, a judgment is made about a single materiality amount for the financial statements taken as a whole. (However, the auditor may determine more than one level of planning materiality for particular items in the financial statements if there are items for which a lesser amount is more appropriate.) In evaluation, an auditor is considering the effect of misstatements on specific amounts, subtotals, or totals in financial statements. In this case, it is possible to use a larger amount in evaluating the effect on certain amounts, subtotals, or totals than on others. However, exclusive reliance on a quantitative amount or percentage relationship for determining materiality is not appropriate. Qualitative factors also should be considered. AEBP, Paragraph 5.36, states that qualitative factors for employee benefit plan financial statements may include the following:

- A misstatement that changes the financial status of a plan from overfunded to underfunded.
- A misstatement that changes the regulatory funding requirements of a defined benefit pension plan.
- The potential effect of the misstatement on a plan’s compliance with ERISA regulations or tax-qualified status.
- Whether the misstatement is an indication of a potential prohibited transaction.

If, as the audit progresses or when evaluating audit findings, the auditor concludes that a lower materiality level than the amount determined during audit planning is appropriate, the auditor should reconsider the related levels of tolerable misstatement and the sufficiency of the further audit procedures that were performed. If the auditor believes a misstatement is, or may be, the result of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, as described in SAS No. 99, even if the effect of the misstatement is not material to the financial statements.

**Overall Evaluation.** If the auditor believes the financial statements are materially misstated, the auditor should request that management make the necessary corrections. If management refuses, the auditor must determine the implication for the auditor’s report.

Even if the auditor believes that the effects of uncorrected misstatements do not cause the financial statements to be materially misstated, the auditor should consider the risk of further misstatement before reaching a final conclusion. According to SAS No. 107 (AU 312.65), even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further misstatement remaining undetected. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 material and uncorrected misstatement is $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is very close to $20,000, the risk may be considered unacceptably high.
Evaluating the Existence of Fraud

If the auditor believes fraud may have occurred, even if the effect is immaterial to the financial statements, the auditor should evaluate its implications for the audit. Those implications may be more significant if plan management is involved. If plan management is involved, questions about plan management’s integrity may raise doubts about the auditor’s ability to rely on representations made during the audit. In that case, the auditor should reevaluate his or her assessment of fraud risks and reconsider the adequacy of audit procedures and the control risk assessment.

If the auditor believes fraud may have occurred that is material to the financial statements, or if he or she is unable to evaluate its materiality, the auditor should:

a. attempt to determine whether material fraud has occurred and its effects on the financial statements and auditor’s report;

b. discuss the matter and the approach for any further investigation with an appropriate level of management (at least one level above those involved), and those charged with governance;

c. suggest that the client consult with legal counsel, if appropriate; and

d. consider the implications for other aspects of the audit.

In some cases, the risk of material misstatement of the financial statements due to fraud is so significant that auditors should consider withdrawing from the engagement and communicating the reasons for their withdrawal to those charged with governance. The decision to withdraw may depend on whether the identified risks call into question the integrity of plan management and whether plan management or others with oversight are diligent and cooperative in investigating the situation and taking appropriate action. If the auditors are considering withdrawal from the engagement, they should consult with legal counsel.

Documentation Requirements

To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. SAS No. 107 (AU 312.69) states that the auditor should prepare documentation of the following:

- A summary of uncorrected misstatements, other than trivial ones, related to known and likely misstatements.

- The auditor’s conclusion as to whether uncorrected misstatements, individually or in the aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

- All known and likely misstatements identified by the auditor during the audit, other than trivial ones, that have been corrected by management.

Summary of Audit Differences. An auditor has to combine, or aggregate, the effect on the financial statements of all likely misstatements (including known misstatements) to evaluate whether the financial statements taken as a whole are materially misstated. According to SAS No. 107, misstatements should be combined in a way that enables the auditor to consider whether the misstatements in individual amounts, subtotals, or totals in the financial statements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals.

Auditors are generally familiar with two approaches to evaluating the effect of prior-period waived misstatements when aggregating audit differences: the rollover method and the iron curtain method. The rollover method considers the net effect of current and prior-period waived adjustments on current period changes in net assets. The iron curtain method compares the accumulated effect of both current and prior-period waived adjustments in the statement of net assets to the current period change in net assets. Both approaches can be used to determine whether misstatements are material.
Evaluation of Overall Materiality

The combined effect of uncorrected misstatements on various financial statement components (amounts, subtotals, or totals) should be compared to the amount that the auditor considers material to the financial statements taken as a whole. The auditor’s judgments about materiality in audit planning may be different than materiality used in evaluating audit findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. For example, while performing the audit, the auditor may become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider tolerable misstatement and appropriateness of the nature, timing, and extent of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. There are numerous common deficiencies that are found when peer reviews are completed on employee benefit plan audits. Being aware of these deficiencies can help with a supervisory review of the workpapers. Which of the following is not a common deficiency that was noted in the Audit Risk Alert?

   a. Insufficient testing of investments held by the benefit plan.
   b. Disclosures that are inadequate for participant-directed investment programs.
   c. Using an exemption for limited-scope audits when the benefit plan is eligible.
   d. Excluding the supplemental schedules required by ERISA and DOL in the benefit plan financials.

20. Which of the following is a mandatory requirement at the end of an audit to assess the impact of the misstatements that were identified by the auditors during the audit?

   a. The documentation and basis for the auditor’s conclusions about the benefit plan audit.
   b. A determination of whether audit risk has been reduced to an appropriate level by the completion of the audit.
   c. An assessment of the audit differences and whether they point to any possible fraud in the audit.
   d. A required management representation letter from plan management confirming oral representations given to the auditors.

21. In which of the following scenarios has a known misstatement of audit difference occurred?

   a. Alex has determined that there is probably an error in the bonus accruals completed and booked by the client. Alex came to this conclusion by completing analytical procedures as part of the audit process.
   b. Steven’s client misapplied the accounting treatment for leases because the lease was incorrectly identified as an operating lease instead of a capital lease. Steven discovered this error during the completion of the audit.
   c. The client valued a property that they purchased last year based on the purchase price a competitor paid for their last property purchase. Melissa, the client’s auditor, does not feel this is appropriate and thinks the property should be valued on the current market.

22. Andrew is completing the audit of No-Leak Plumbing supplies. He has set his misstatement levels at greater than $5,000. Which of the following misstatements are considered trivial and would not need to be included in the summary of audit differences?

   a. After reconciling cash, Andrew has discovered that it was overinflated by $2,000. In addition, there was a theft to petty cash of $500.
   b. Andrew has discovered that PP&E was overstated by $6,500, but accumulated depreciation was understated by $6,500.
   c. The value of an investment that No-Leak Plumbing holds is undervalued by $10,000 based on market research.
   d. No-Leak Plumbing has overstated net assets by $10,000, understated net liabilities by $6,500 and understated PP&L by $3,500.
23. Which of the following is correct regarding the appraisal of estimates in the audit?

a. If the client’s estimate does not fall within the acceptable range that the auditor has identified, they should discuss it and decide which is more plausible.

b. If management always chooses estimates from the low end of the range that the auditor considers reasonable, then the estimates are conservative, which keeps the financials in a favorable light.

c. The auditors should be responsible for recognition of all material accounting estimates, including deciding whether any accounting estimates are needed.

d. Auditors should review prior year estimates when completing the current year audit to make sure the judgments and assumptions did not contain any biases.

24. Karen has determined that fraud has occurred in regards to valuing the securities included in the benefit plan of Hi-Tow Industries. She believes the controller is in cahoots with the broker of the securities to undervalue the securities and skim a portion off the top. She has investigated the fraud to determine if its effects are material to the financial statements of the benefit plan, she has discussed the matter with the controller, and she has advised the CFO of Hi-Two Industries to consult with legal counsel. Karen is contemplating the consequences of this discovery on the overall audit of the benefit plan. Which of Karen’s actions is improper when evaluating the existence of fraud?

a. Advise the CFO of Hi-Tow Industries to seek consultation with legal counsel.

b. Discussing the fraudulent matter with the controller of Hi-Two Industries.

c. Attempting to decide if the effect of the fraud is material to the financial statements of the benefit plan.

d. Deliberate the consequences for the audit, based on the possibility of the fraud.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

19. There are numerous common deficiencies that are found when peer reviews are completed on employee benefit plan audits. Being aware of these deficiencies can help with a supervisory review of the workpapers. Which of the following is not a common deficiency that was noted in the Audit Risk Alert? (Page 297)

   a. Insufficient testing of investments held by the benefit plan. [This answer is incorrect. Inadequate testing of investments, particularly when the investments are held by outside parties, is a common deficiency noted by the AICPA in their Audit Risk Alert related to benefit plan audits.]

   b. Disclosures that are inadequate for participant-directed investment programs. [This answer is incorrect. One of the deficiencies noted in the Audit Risk Alert by the AICPA, Employee Benefit Plans Industry Developments—2008, is inadequate disclosures related to participant-directed investment programs. Reviewers of benefit plan workpapers should be aware and make sure all disclosures are adequate.]

   c. Using an exemption for limited-scope audits when the benefit plan is eligible. [This answer is correct. It is proper for a benefit plan to use a limited-scope exemption when it is appropriate. But, according to the AICPA peer review, a common deficiency is when the limited-scope exemption is used improperly because the benefit plan did not qualify for such an exemption.]

   d. Excluding the supplemental schedules required by ERISA and DOL in the benefit plan financials. [This answer is incorrect. Per the AICPA Audit Risk Alert related to benefit plan audits, a common deficiency in benefit plan audits is the failure to properly include the required supplemental schedules related to ERISA and DOL.]

20. Which of the following is a mandatory requirement at the end of an audit to assess the impact of the misstatements that were identified by the auditors during the audit? (Page 297)

   a. The documentation and basis for the auditor’s conclusions about the benefit plan audit. [This answer is incorrect. SAS No. 103 does require the auditor to document significant audit findings or issues, actions taken and evidence obtained in addressing them, and the basis for the auditor’s conclusions in the conclusion of the audit, but not to assess the impact of the material misstatements. This is done to provide documentation of the procedures that were performed during the audit and the reasons why they were executed.]

   b. A determination of whether audit risk has been reduced to an appropriate level by the completion of the audit. [This answer is incorrect. SAS No. 110 (AU 318.74) requires the auditor to evaluate whether audit risk has been reduced to an appropriately low level and whether the nature, timing and extent of audit procedures may need to be reconsidered. While this does consider the misstatements, it assesses the audit risk level rather than the impact of the misstatements. It should be completed in the conclusion of the audit.]

   c. An assessment of the audit differences and whether they point to any possible fraud in the audit. [This answer is correct. One of the final steps near completion of the engagement as required by SAS No. 99 (AU 316.75) requires audit differences to be evaluated as to whether they are indicative of possible fraud.]

   d. A required management representation letter from plan management confirming oral representations given to the auditors. [This answer is incorrect. A management representation is required by SAS No. 85 as part of the completion of the audit. The management representation letter will not assess the impact of the misstatements identified by the auditors during the audit, the letter is part of the evidential matter the auditor obtains.]
21. In which of the following scenarios has a known misstatement of audit difference occurred? (Page 298)

   a. Alex has determined that there is probably an error in the bonus accruals completed and booked by the client. Alex came to this conclusion by completing analytical procedures as part of the audit process. [This answer is incorrect. This would be classified as a likely misstatement. Misstatements that are likely misstatements are ones the auditor deems likely to exist resulting from extrapolation from audit evidence obtained.]

   b. Steven's client misapplied the accounting treatment for leases because the lease was incorrectly identified as an operating lease instead of a capital lease. Steven discovered this error during the completion of the audit. [This answer is correct. This misstatement would be classified as a known misstatement. A known misstatement arises from the incorrect selection or misapplication of accounting principles or misstatements of facts identified. They are normally identified when the auditor is performing audit procedures.]

   c. The client valued a property that they purchased last year based on the purchase price a competitor paid for their last property purchase. Melissa, the client's auditor, does not feel this is appropriate and thinks the property should be valued on the current market. [This answer is incorrect. Misstatements that arise from differences between judgments made by management and the auditor about accounting estimates that the auditor believes are unreasonable or inappropriate are likely misstatements, not known misstatements.]

22. Andrew is completing the audit of No-Leak Plumbing supplies. He has set his misstatement levels at greater than $5,000. Which of the following misstatements are considered trivial and would not need to be included in the summary of audit differences? (Page 299)

   a. After reconciling cash, Andrew has discovered that it was overinflated by $2,000. In addition, there was a theft to petty cash of $500. [This answer is correct. Andrew does not have to include the differences to cash since the aggregate amount of differences in cash is less than the $5,000 limit he had set for misstatements in the audit. This amount is considered trivial. Footnote 17 to AU 312.42 states that "trivial" matters are amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered."

   b. Andrew has discovered that PP&E was overstated by $6,500, but accumulated depreciation was understated by $6,500. [This answer is incorrect. Although the two amounts would offset each other in the aggregate, the auditor must consider both the individual and aggregate effects of all uncorrected misstatements. Taken alone, each of these exceed the misstatement limit and should be included in the summary of audit differences.]

   c. The value of an investment that No-Leak Plumbing holds is undervalued by $10,000 based on market research. [This answer is incorrect. The $10,000 difference is greater than the misstatement threshold that Andrew has determined to be reported as detected misstatements. According to SAS No. 107, the auditor needs to evaluate whether the financial statements taken as a whole are free from material misstatement.]

   d. No-Leak Plumbing has overstated net assets by $10,000, understated net liabilities by $6,500 and understated PP&L by $3,500. [This answer is incorrect. These amounts, in the aggregate, offset each other, but the auditor must consider both the individual and aggregate effects of all uncorrected misstatements. In the aggregate they zero out, but individually, the overstatement in net assets and the understatement in net liabilities would need to be included in the summary of audit differences according to SAS No. 107.]
23. Which of the following is correct regarding the appraisal of estimates in the audit? *(Page 301)*

a. If the client’s estimate does not fall within the acceptable range that the auditor has identified, they should discuss it and decide which is more plausible. [This answer is incorrect. After the auditor has decided what estimate is reasonable, if the client’s estimate falls within this range, it is acceptable. If it falls outside the range, the difference between the client’s estimate and the closest end of the auditor’s range should be considered likely misstatement and summarized with the other audit differences as indicated in SAS No. 57.]

b. If management always chooses estimates from the low end of the range that the auditor considers reasonable, then the estimates are conservative, which keeps the financials in a favorable light. [This answer is incorrect. SAS No. 107 states that an auditor should consider whether differences between estimates best supported by the audit evidence and the estimates included in the financial statements are individually reasonable. If plan management always chooses estimated amounts for the valuation of investments that are at the low end of the range the auditor considers reasonable, the combined effect could result in a material misstatement of net assets.]

c. The auditors should be responsible for recognition of all material accounting estimates, including deciding whether any accounting estimates are needed. [This answer is incorrect. SAS No. 57 highlights the importance of evaluation when management, not the audit team, has identified all material accounting estimates. The SAS also recommends that the auditor inquire of management about whether there are circumstances that indicate the need for an accounting estimate.]

d. Auditors should review prior year estimates when completing the current year audit to make sure the judgments and assumptions did not contain any biases. [This answer is correct. SAS No. 99 requires the auditor to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. This review may provide additional information about whether the current year’s estimates could be biased.]

24. Karen has determined that fraud has occurred in regards to valuing the securities included in the benefit plan of Hi-Tow Industries. She believes the controller is in cahoots with the broker of the securities to undervalue the securities and skim a portion off the top. She has investigated the fraud to determine if its effects are material to the financial statements of the benefit plan, she has discussed the matter with the controller, and she has advised the CFO of Hi-Two Industries to consult with legal counsel. Karen is contemplating the consequences of this discovery on the overall audit of the benefit plan. Which of Karen’s actions is improper when evaluating the existence of fraud? *(Page 302)*

a. Advise the CFO of Hi-Tow Industries to seek consultation with legal counsel. [This answer is incorrect. Karen should suggest to the client that they consult with legal counsel, if appropriate. The fraud could involve a criminal investigation if the people involved have been stealing from the company.]

b. Discussing the fraudulent matter with the controller of Hi-Two Industries. [This answer is correct. Karen should not discuss the matter with the person whom she thinks is involved with the fraud. She should discuss the matter and the approach for further investigation with the appropriate level of management, at least one level above who is involved, the audit committee and others charged with governance. By discussing it with the possible perpetrator of the fraud, Karen could have compromised the investigation.]

c. Attempting to decide if the effect of the fraud is material to the financial statements of the benefit plan. [This answer is incorrect. Karen should attempt to determine whether material fraud has occurred and its effects on the financial statements since this influences the audit she was engaged to perform and the results of her audit report.]

d. Deliberate the consequences for the audit, based on the possibility of the fraud. [This answer is incorrect. Karen should consider the implications for other aspects of the audit if the fraud is determined to be material and factual. It could change the outcome of the opinion that Karen would issue for the client.]
EXAMINATION FOR CPE CREDIT

Lesson 2 (EBPTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Drew is completing an audit of the employee benefit plan for Hightower Productions. The company is unwilling to provide Drew with a management representation letter. How does this affect Drew’s opinion on the plan’s financial statements?
   
   a. It does not affect Drew’s opinion.
   
   b. Drew can issue an unqualified opinion.
   
   c. An adverse opinion is the only choice with this limitation.
   
   d. The refusal could prevent Drew from issuing an unqualified opinion.

12. Michael has encountered issues on the audit of the benefit plan of his current client and has decided he must issue a disclaimer of opinion. Should Michael still require the client to provide him with a management representation letter?
   
   a. Yes.
   
   b. No.
   
   c. Do not select this answer choice.
   
   d. Do not select this answer choice.

13. Who would be the appropriate person to provide the management representation letter to the auditor of the benefit plan?
   
   a. The human resources director in charge of determining benefits.
   
   b. The plan’s accounting officer managing the plan.
   
   c. The president of the company providing the benefit plan to employees.
   
   d. The chief information officer of the plan sponsor.

14. Deviations can occur when applying controls to determine material misstatements. Which of the following is not a factor that can influence deviations?
   
   a. Errors committed by the auditor.
   
   b. Adjustments to key personnel in the company.
   
   c. Variations in activity due to the seasons.
   
   d. The auditor’s inadequate knowledge of the industry.
15. Which of the following analytical procedures is most important when determining the risk of misstatement due to fraud in benefit plans?
   a. Trending the revenue of the benefit plan.
   b. Observing the movement of the cash account.
   c. Assessing the investment valuation.
   d. Vouching invoices to the accounts payable account.

16. Why does the auditor test for significant unusual transactions?
   a. To confirm that management has not superseded the internal control structure.
   b. To determine if any going concern issues exist.
   c. To locate previously unidentified material misstatement due to fraud.
   d. To investigate for related-party and party in interest prohibited transactions.

17. What is an explanation, in narrative form and by financial statement caption, that shows the difference from the prior period to the current period in the financial statements, highlighting the unusual or unexpected relationships between the two periods?
   a. Reportable transaction.
   b. Material inconsistency.
   c. Significant deficiency.
   d. Flux analysis.

18. Which of the following steps should be completed to ensure sufficient appropriate evidence is met in a benefit plan audit?
   a. The auditors have accepted accountability for the financial statements.
   b. The preparation of the financial statements and related disclosures has been finalized.
   c. Audit documentation has been prepared for the benefit plan audit.
   d. A review checklist has been completed and inserted in the audit workpapers.

19. According to the text, which of the following would be considered a normal closing entry when categorizing misstatements?
   a. Monthly bonus accrual based on the company’s incentive compensation plan.
   b. Depreciation journal entry based on the property, plant and equipment records.
   c. An adjustment to an accrual booked by the client, decided in the completion of the audit.
   d. The booking of revenue and cost of sales based on sales reports.
20. When evaluating audit differences, an auditor should consider both quantitative and qualitative factors. When the auditor is deliberating the inappropriate application of an accounting principle due to a misunderstanding between the client and the auditor, which of the following are they considering?

a. Effect.


c. Cause.

d. Amount.

21. Which of the following accounting estimates would be more applicable when an auditor is engaged to audit an employee benefit plan?

a. The estimation of the value of securities.

b. The current value of a company’s real estate holdings.

c. The assessment of a company’s contract with their largest client.

d. An estimate on the depreciation of the company’s fixed assets.

22. Which of the following is an example of a quantitative factor versus a qualitative factor?

a. The misstatement is a possible prohibited transaction.

b. The plan’s status would change from underfunded to overfunded based on the misstatement.

c. The plan’s compliance for tax-qualified status is jeopardized based on the misstatement.

d. Loan loss allowances for benefit plan participant loans.

23. SAS No. 107 explains the documentation required by the auditor to assess the effect of various uncorrected misstatements. Which of the following is not required by SAS No. 107?

a. The recognition by the auditor of misstatements, classified as known or likely, that were corrected by management during the audit.

b. The audit procedures to determine the level of materiality to apply to the financial statements when completing the audit.

c. A summary of audit differences that were not corrected, other than trivial misstatements.

d. A summary from the auditor as to whether the financial statements are materially misstated based on the uncorrected misstatements.

24. Justin is auditing the benefit plan financials of Green Parrot Beverages. The audit team is evaluating current-period misstatements and adjustments that were waived in the prior period to determine their effect on changes in net assets in the current period. What method is the audit team using to aggregate audit differences?

a. The iron curtain method.

b. The rollover method.

c. Do not select this answer choice.

d. Do not select this answer choice.
Lesson 3: The Preparation of Financial Statements and the Required Communication from the Auditor

INTRODUCTION

This lesson discusses the auditor’s accountability for the preparation of the financial statements and related required supplemental schedules, and the required communication and timing of the communications to those charged with governance.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the auditor’s responsibility for the financial statements and the required supplemental schedules.
- Discuss the communication that is required by the auditor to those charged with governance concerning internal control, the resulting deficiencies, and the methods and timing of expected communications.

Financial Statements

In many employee benefit plan audit engagements, the auditor drafts or assists with drafting the financial statements. Plan management must understand that the auditor’s involvement in drafting the financial statements does not change the fact that plan management is responsible for the financial statements. Plan management is expected to acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, plan management must agree to accept this responsibility, and the auditor should be satisfied that plan management has the ability to do so. The auditor’s understanding with the client regarding preparation of the financial statements should be documented. The auditor should discuss the representation letter with plan management so they understand the meaning and significance of acknowledging responsibility for the financial statements.

Plan management must also understand that the auditor’s involvement in financial statement preparation may represent a significant deficiency or material weakness in internal control that must be communicated, in writing, to plan management and those charged with governance. Under SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit, if the auditor prepares the financial statements because the client lacks sufficient expertise to do so and lacks the skills and competencies necessary to prevent, detect, and correct a material misstatement, this represents a control deficiency that is most likely a significant deficiency or material weakness. SAS No. 115, including issues related to the auditor’s involvement in financial statement preparation, is discussed later in this lesson.

Schedule H of Form 5500 constitutes financial statements. The instructions to Form 5500 and DOL regulations [Reg. 2520.103-1(b)(2)] require the Form 5500 to be accompanied by separate, attached financial statements if such statements are prepared for the auditor to form an opinion.

The separate financial statements must include all the information required in Schedule H of Form 5500, but the statements may be aggregated in different categories than those required in Schedule H. However, the DOL regulations [Reg. 2520.103-1(b)(3)] require the notes to the separate financial statements to explain any variances from GAAP or differences between the information reported in the separate statements and in Schedule H. The DOL has cited omission of such a note reconciliation as a frequent deficiency in filings it has reviewed. The DOL may reject filings that do not include such a reconciliation. Besides any differences arising from different categorizations, differences may result from matters such as the following:

- The Form 5500 requirement to value property used in plan operations at fair value and the GAAP requirement to use cost for such assets.
- The different method of calculating realized gains and losses on assets required in line 2b(4) of Schedule H to Form 5500 (2008) and the method used under GAAP.
- A Form 5500 liability for assets that have been allocated to participants who have withdrawn from the plan as of year end, but for which disbursement of those funds from the plan have not yet been made and a liability is not recorded for GAAP purposes.

- The Form 5500 requirement to include the assets of 401(h) accounts in the defined benefit plan’s Form 5500 and the GAAP requirement to present those assets in the health and welfare plan’s statement of net assets available for benefits.

- The Form 5500 requirement to report fully benefit-responsive investment contracts held by defined contribution health and welfare and pension plans at current value and the GAAP requirement to report such investments at contract value in the balance of net assets available for benefits.

- The Form 5500 prepared (by another party) on the “modified cash” basis and the financial statements prepared on the accrual basis.

The separate financial statements, as well as the schedules and auditor’s reports discussed in subsequent paragraphs, must be submitted to the EBSA along with the Form 5500. They may not be filed separately from the Form 5500.

**Notes to the Financial Statements**

The notes to the financial statements are an integral part of the financial statements. In fact, SFAS No. 35 (FASB ASC 960) allows benefit obligation information for a defined benefit retirement plan to be presented in the notes instead of in a separate statement or on the face of another statement. In addition, SOP 92-6 (FASB ASC 965), as amended, allows health and welfare benefit plans to present information about benefit obligations in the notes to financial statements. The information is tested when the related financial statement area is tested. Information on benefit obligations presented in the notes is audited the same as if it were presented in a separate statement.

DOL regulations [Reg. 2520.103-1(b)(3)] require note disclosures on certain specific matters, including the accounting principles; variances from GAAP; a description of the plan, its funding policy, and termination priorities; whether the plan has obtained a tax determination letter; errors, irregularities, and illegal acts; loss contingencies; related-party and party-in-interest agreements and transactions; lease and other commitments; and unusual, infrequent, or subsequent events. These disclosures are also required by GAAP, including specifically SFAS No. 35 (FASB ASC 960), AEBP, and SOP 92-6 (FASB ASC 965). The notes must also disclose differences between the attached audited financial statements and the statements in Schedule H of Form 5500. Also, some disclosures required to be made in the notes to the financial statements are also required to be made in supplemental schedules. Inclusion of information in the notes will not substitute for its inclusion in the required supplemental schedules, and thus, some disclosures may have to appear in both places.

It can be a problem determining that all of the disclosures required by GAAP, Form 5500, and the DOL regulations are made. The use of a disclosure checklist is a best practice employed. The checklists are not GAAP application or presentation checklists, but they do include some general guidance on financial statement classification and format that may be useful when preparing or reviewing the financial statements. The applicable checklist may be completed and included in the audit documentation or be used as a memory jogger in the review phase of the audit.

**Required Supplemental Schedules**

Several supplemental schedules (including Schedule G to Form 550) must accompany the audited financial statements for the current period and be reported on by the auditor. (The supplemental schedules should not be included for the prior year.) Part IV of Schedule H to Form 5500 includes questions (4a-d, 4i, and 4j) to determine if supplemental schedules are required. If questions 4b, 4c, or 4d are answered “yes,” the applicable parts of Schedule G must be completed and attached to the Form 5500 and the financial statements. If questions 4a, 4i, or 4j are answered “Yes,” a supplemental schedule must be completed in the format specified in the instructions to Schedule H. If one or more of the supplemental schedules, including Schedule G, are not required, the auditor should not refer to those supplemental schedules in his report. For supplemental schedules that are not required, the applicable questions in Part IV of Schedule H should simply be answered “No.” These supplemental schedules
are in addition to Schedules A, MB or SB, C, D, E, H, I, and R that are attached to Form 5500. The questions in Part IV of Schedule H and the required supplemental schedules are as follows:

- **Question 4a—Delinquent Participant Contributions.** If this question is answered “yes,” a supplemental schedule must be prepared providing the relevant details. The instructions to line 4a of Schedules H and I give guidance on reporting delinquent participant contributions and the required column headings. Exhibit 3-1 reproduces those instructions and the required column headings for the schedule.

- **Question 4b—Loans or Fixed Income Obligations in Default or Classified as Uncollectible.** If this question is answered “yes,” Part I of Schedule G must be completed. Exhibit 3-2 presents the Schedule G. (Participant loans in default must be included on this schedule unless the loans are under an individual account plan and secured solely by a portion of the participants’ vested accrued benefit.) The instructions to Part I of Schedule G require a separate attachment describing what steps have been taken or will be taken to collect overdue amounts for each loan listed.

- **Question 4c—Leases in Default or Classified as Uncollectible.** If this question is answered “yes,” Part II of Schedule G must be completed. (Exhibit 3-2 presents the Schedule G.) The instructions to Part II of Schedule G include specific details for determining when a lease is in default or classified as uncollectible. The instructions also require a separate attachment describing what steps have been taken or will be taken to collect overdue amounts for each lease listed.

- **Question 4d—Nonexempt Transactions.** If this question is answered “yes,” Part III of Schedule G must be completed. (Exhibit 3-2 presents the Schedule G.) These nonexempt transactions are transactions with parties in interest (also called prohibited transactions).

- **Question 4i—Assets Held for Investment Purposes.** Actually, two different schedules may be required. One schedule reports assets held for investment purposes at the end of the plan year, and the other reports investment assets that were both acquired and disposed of during the plan year. Essentially, assets reported in line 1c of Schedule H must be detailed in the supplemental schedules, with certain exceptions. The instructions to line 4i of Schedule H specify what constitutes assets held for investment purposes that should be included in these schedules. Note that the schedules must include any participant loans made against individual account balances. The instructions to line 4i give guidance on aggregating such loans and reporting related information in the schedules. Exhibit 3-3 reproduces those instructions and the required column headings for the schedules.

- **Question 4j—Reportable Transactions.** These are transactions, or a series of transactions, exceeding 5% of the current value of plan assets at the beginning of the plan year. For the first plan year, the instructions to line 4j of Schedule H indicates that the 5% figure may be based on the current value of plan assets at the end of the plan year. Additional information on reportable transactions, including examples, is found in DOL Reg. 2520.103-6, “Definition of Reportable Transaction for Annual Return/Report.” Neither the DOL regulations nor Schedule H or its instructions state whether the base amount for measuring the 5% threshold for a reportable transaction should be the plan’s gross assets or net assets. DOL officials have stated publicly that the base amount should be gross (that is, total) assets. Exhibit 3-4 reproduces the instructions to line 4j of Schedule H relating to this schedule and its required column headings. Exhibit 3-5 gives examples of the four basic types of reportable transactions based on the guidance of the DOL regulations and Form 5500 instructions.
Exhibit 3-1

Schedule of Delinquent Participant Contributions

**Line 4a.** Amounts paid by a participant or beneficiary to an employer and/or withheld by an employer for contribution to the plan are participant contributions that become plan assets as of the earliest date on which such contributions can reasonably be segregated from the employer’s general assets (see 29 CFR 2510.3-102). Plans that check “Yes” must enter the aggregate amount of all late contributions for the year. The total amount of the delinquent contributions should be included on line 4a of the Schedule H or I, as applicable, for the year in which the contributions were delinquent and should be carried over and reported again on line 4a of the Schedule H or I, as applicable, for each subsequent year until the year after the violation has been fully corrected, which correction includes payment of the late contributions and reimbursement of the plan for lost earnings or profits. If no participant contributions were received or withheld by the employer during the plan year, answer “No.”

An employer holding these assets after that date commingled with its general assets will have engaged in a prohibited use of plan assets (see ERISA section 406). If such a nonexempt prohibited transaction occurred with respect to a disqualified person [see Code section 4975(e)(2)], file IRS Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans) with the IRS to pay any applicable excise tax on the transaction.

Participant loan repayments paid to and/or withheld by an employer for purposes of transmittal to the plan that were not transmitted to the plan in a timely fashion must be reported either on line 4a in accordance with the reporting requirements that apply to delinquent participant contributions or on line 4d. See Advisory Opinion 2002-02A, available at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

**TIP:** Delinquent participant contributions reported on line 4a should be treated as part of the separate schedules referenced in ERISA section 103(a)(3)(A) and 29 CFR 2520.103-1(b) and 2520.103-2(b) for purposes of preparing the IQPA’s opinion described on line 3 even though they are no longer required to be listed on Part III of the Schedule G. If the information contained on line 4a is not presented in accordance with regulatory requirements, i.e., when the IQPA concludes that the scheduled information required by line 4a does not contain all the required information or contains information that is inaccurate or is inconsistent with the plan’s financial statements, the IQPA report must make the appropriate disclosures in accordance with generally accepted auditing standards. For more information, see EBSA’s Frequently Asked Questions About Reporting Delinquent Contributions on the Form 5500, available on the Internet at [www.dol.gov/ebsa](http://www.dol.gov/ebsa). These Frequently Asked Questions clarify that plans have an obligation to include delinquent participant contributions on their financial statements and supplemental schedules and that the IQPA’s report covers such delinquent contributions even though they are not required to be included on Part III of the Schedule G. Although all delinquent participant contributions must be reported on line 4a, delinquent contributions for which the DOL VFCP requirements and the conditions of PTE 2002-51 have been satisfied do not need to be treated as nonexempt party-in-interest transactions.

The VFCP describes how to apply, the specific transactions covered (which transactions include delinquent participant contributions to pension and welfare plans), and acceptable methods for correcting violations. In addition, applicants that satisfy both the VFCP requirements and the conditions of PTE 2002-51 are eligible for immediate relief from payment of certain prohibited transaction excise taxes for certain corrected transactions, and are also relieved from the obligation to file the IRS Form 5330 with the IRS. For more information, see 71 Fed. Reg. 20261 (Apr. 19, 2006) and 71 Fed. Reg. 20135 (Apr. 19, 2006). Information about the VFCP is also available on the Internet at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

All delinquent participant contributions must be reported on line 4a even if violations have been corrected.

**Line 4a Schedule.** Attach a Schedule of Delinquent Participant Contributions using the format below if you entered “Yes.” If you chose to include participant loan repayments on line 4a, you must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as applied to delinquent transmittals of participant contributions.
Some information required to be disclosed in the notes to the financial statements is also required to be included in a supplemental schedule. Inclusion of the information in the notes will not substitute for its inclusion in the required supplemental schedules. AEBP, Paragraph 95, states that “any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information in the footnotes to the financial statements but not in the schedules is not acceptable to the DOL.” This requirement applies to retirement benefit plans as well as to welfare benefit plans. Thus, a disclosure that would also be required in the notes would have to be reported both in the notes and in a supplemental schedule. For example, GAAP requires note disclosure of investments that represent 5% or more of plan assets. Even if all plan investments were disclosed in the note, they should still be reported in the supplemental schedule of investments required by line 4i of Schedule H. As another example, GAAP requires note disclosure of material prohibited transactions, and line 4d specifically calls for a schedule of prohibited (nonexempt) transactions.

Some of the supplemental schedules include a column for “cost,” “original cost,” or “purchase price.” The DOL does not require one specific method for determining cost, such as average cost. Any generally accepted method of determining historical cost may be used as long as the method is used consistently and is clearly defined.

The supplemental schedules should report information on investment gains and losses using the GAAP method, and not the method required for reporting such gains and losses in line 2b of Schedule H (2009). Also, the supplemental schedules should be on the same basis of accounting as the audited financial statements. The auditor should be aware that a trustee may provide information on plan investments or reportable transactions that is not on the GAAP basis. For example, the information may be on the cash basis or may use settlement date rather than trade date accounting. In either a full-scope audit or a DOL limited-scope audit, the auditor may have to make adjustments to such information to put it on the GAAP basis for inclusion in the supplemental schedules. In addition, if the information received from the trustee or custodian is inaccurate, incomplete, or inconsistent with the financial statements and supplemental schedules, the auditor should consider modifying his or her report on the supplemental schedules. An example would be historical cost information not being provided by the trustee or custodian so the plan could not properly complete the schedule of assets held for investment.

The instructions to Schedules G and H give very specific requirements for these supplemental schedules’ content and format. The filing will be rejected if the exact required format is not used. Thus, for instance, if an investment custodian or trustee furnishes the plan with a schedule of investments held that contains all the required information, it may not be used for the supplemental schedule unless it is in the required format.

DOL regulations and the instructions to Form 5500 (2009) call for the supplemental schedules (including Schedule G) to be “attached to” the “return/report.” The audited financial statements should include these schedules (if applicable). However, copies of the schedules should also be attached to the Form 5500—clearly and fully labeled. The schedules should be electronically transmitted at the time the Form 5500 is transmitted. (Details of the DOL filing system can be found at www.efast.dol.gov.)
### Exhibit 3-2

**Schedule G to Form 5500**

**Financial Transaction Schedules**

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 (ERISA) and section 6055(a) of the Internal Revenue Code (the Code).

> File as an attachment to Form 5500.

For calendar plan year 2009 or fiscal plan year beginning

and ending

<table>
<thead>
<tr>
<th>A</th>
<th>Name of plan:</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Three-digit plan number (PN)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C</th>
<th>Plan sponsor’s name as shown on line 2a of Form 5500</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>Employer Identification Number (EIN):</td>
</tr>
</tbody>
</table>

#### Part I

**Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible**

Complete as many entries as needed to report all loans or fixed income obligations in default or classified as uncollectible. Check box (a) if obligor is known to be a party in interest. Attach Overdue Loan Explanation for each loan listed. See instructions.

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b) Identity and address of obligor</th>
</tr>
</thead>
<tbody>
<tr>
<td>(c)</td>
<td>Detailed description of loan including dates of making and maturity, interest rate, the type and value of collateral, any renegotiation of the loan and the terms of the renegotiation, and other material items</td>
</tr>
</tbody>
</table>

| (d) Original amount of loan |
|---|---|
| (e) Principal |
| (f) Interest |
| (g) Unpaid balance at end of year |
| (h) Principal |
| (i) Interest |

For Paperwork Reduction Act Notice and OMB Control Numbers, see the instructions for Form 5500.

Schedule G (Form 5500) 2009

v.092308.1
<table>
<thead>
<tr>
<th>Schedule G (Form 5500) 2009</th>
<th>Page 2-</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b) Identity and address of obligor</td>
</tr>
<tr>
<td>(e) Principal</td>
<td>(f) Interest</td>
</tr>
<tr>
<td>Amount received during reporting year</td>
<td>Amount overdue</td>
</tr>
<tr>
<td>(d) Original amount of loan</td>
<td>(e) Principal</td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity and address of obligor</td>
</tr>
<tr>
<td>(e) Principal</td>
<td>(f) Interest</td>
</tr>
<tr>
<td>Amount received during reporting year</td>
<td>Amount overdue</td>
</tr>
<tr>
<td>(d) Original amount of loan</td>
<td>(e) Principal</td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity and address of obligor</td>
</tr>
<tr>
<td>(e) Principal</td>
<td>(f) Interest</td>
</tr>
<tr>
<td>Amount received during reporting year</td>
<td>Amount overdue</td>
</tr>
<tr>
<td>(d) Original amount of loan</td>
<td>(e) Principal</td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity and address of obligor</td>
</tr>
<tr>
<td>(e) Principal</td>
<td>(f) Interest</td>
</tr>
<tr>
<td>Amount received during reporting year</td>
<td>Amount overdue</td>
</tr>
<tr>
<td>(d) Original amount of loan</td>
<td>(e) Principal</td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity and address of obligor</td>
</tr>
<tr>
<td>(e) Principal</td>
<td>(f) Interest</td>
</tr>
<tr>
<td>Amount received during reporting year</td>
<td>Amount overdue</td>
</tr>
<tr>
<td>(d) Original amount of loan</td>
<td>(e) Principal</td>
</tr>
</tbody>
</table>

321
### Part II
#### Schedule of Leases in Default or Classified as Uncollectible

Complete as many entries as needed to report all leases in default or classified as uncollectible. Check box (a) if lessor or lessee is known to be a party in interest. Attach Overdue Lease Explanation for each lease listed. (See instructions)

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b) Identity of lessor/lessee</th>
<th>(c) Relationship to plan, employer, employee organization or other party-in-interest</th>
<th>(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e)</td>
<td>Original cost</td>
<td>(f) Current value at time of lease</td>
<td>(g) Gross rental receipts during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(h) Expenses paid during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(i) Net receipts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(j) Amount in arrears</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity of lessor/lessee</td>
<td>(c) Relationship to plan, employer, employee organization or other party-in-interest</td>
<td>(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e)</td>
<td>Original cost</td>
<td>(f) Current value at time of lease</td>
<td>(g) Gross rental receipts during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(h) Expenses paid during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(i) Net receipts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(j) Amount in arrears</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity of lessor/lessee</td>
<td>(c) Relationship to plan, employer, employee organization or other party-in-interest</td>
<td>(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e)</td>
<td>Original cost</td>
<td>(f) Current value at time of lease</td>
<td>(g) Gross rental receipts during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(h) Expenses paid during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(i) Net receipts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(j) Amount in arrears</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity of lessor/lessee</td>
<td>(c) Relationship to plan, employer, employee organization or other party-in-interest</td>
<td>(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e)</td>
<td>Original cost</td>
<td>(f) Current value at time of lease</td>
<td>(g) Gross rental receipts during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(h) Expenses paid during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(i) Net receipts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(j) Amount in arrears</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b) Identity of lessor/lessee</td>
<td>(c) Relationship to plan, employer, employee organization or other party-in-interest</td>
<td>(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e)</td>
<td>Original cost</td>
<td>(f) Current value at time of lease</td>
<td>(g) Gross rental receipts during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(h) Expenses paid during the plan year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(i) Net receipts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(j) Amount in arrears</td>
</tr>
</tbody>
</table>
## Part III Nonexempt Transactions

Complete as many entries as needed to report all nonexempt transactions. Caution: If a nonexempt prohibited transaction occurred with respect to a disqualified person, file Form 5330 with the IRS to pay the excise tax on the transaction.

<table>
<thead>
<tr>
<th>(a) Identity of party involved</th>
<th>(b) Relationship to plan, employer, or other party-in-interest</th>
<th>(c) Description of transaction including maturity date, rate of interest, collateral, par or maturity value</th>
<th>(d) Purchase price</th>
</tr>
</thead>
<tbody>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
<tr>
<td>(a) Identity of party involved</td>
<td>(b) Relationship to plan, employer, or other party-in-interest</td>
<td>(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value</td>
<td>(d) Purchase price</td>
</tr>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
<tr>
<td>(a) Identity of party involved</td>
<td>(b) Relationship to plan, employer, or other party-in-interest</td>
<td>(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value</td>
<td>(d) Purchase price</td>
</tr>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
<tr>
<td>(a) Identity of party involved</td>
<td>(b) Relationship to plan, employer, or other party-in-interest</td>
<td>(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value</td>
<td>(d) Purchase price</td>
</tr>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
<tr>
<td>(a) Identity of party involved</td>
<td>(b) Relationship to plan, employer, or other party-in-interest</td>
<td>(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value</td>
<td>(d) Purchase price</td>
</tr>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
<tr>
<td>(a) Identity of party involved</td>
<td>(b) Relationship to plan, employer, or other party-in-interest</td>
<td>(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value</td>
<td>(d) Purchase price</td>
</tr>
<tr>
<td>(e) Selling price</td>
<td>(f) Lease rental</td>
<td>(g) Transaction expenses</td>
<td>(h) Cost of asset</td>
</tr>
</tbody>
</table>

* * *
Exhibit 3-3

Schedules of Assets Held for Investment Purposes

**Line 4i.** Check "Yes" if the plan had any assets held for investment purposes, and attach a schedule of assets held for investment purposes at end of year, a schedule of assets held for investment purposes that were both acquired and disposed of within the plan year, or both, as applicable. The schedules must use the format set forth below or a similar format. See 29 CFR 2520.103-11.

Assets held for investment purposes shall include:

- Any investment asset held by the plan on the last day of the plan year; and
- Any investment asset purchased during the plan year and sold before the end of the plan year except:
  
  1. Debt obligations of the U.S. or any U.S. agency.
  2. Interests issued by a company registered under the Investment Company Act of 1940 (e.g., a mutual fund).
  3. Bank certificates of deposit with a maturity of one year or less.
  4. Commercial paper with a maturity of 9 months or less if it is valued in the highest rating category by at least two nationally recognized statistical rating services and is issued by a company required to file reports with the Securities and Exchange Commission under Section 13 of the Securities Exchange Act of 1934.
  5. Participations in a bank common or collective trust.
  6. Participations in an insurance company pooled separate account.
  7. Securities purchased from a broker-dealer registered under the Securities Exchange Act of 1934 and either: (1) listed on a national securities exchange and registered under Section 6 of the Securities Exchange Act of 1934, or (2) quoted on NASDAQ.

Assets held for investment purposes shall not include any investment that was not held by the plan on the last day of the plan year if that investment is reported in the annual report for that plan year in any of the following:

1. The schedule of loans or fixed income obligations in default required by Schedule G, Part I;
2. The schedule of leases in default or classified as uncollectible required by Schedule G, Part II;
3. The schedule of non-exempt transactions required by Schedule G, Part III; and
4. The schedule of reportable transactions required by Schedule H, line 4j.

**Line 4i Schedules.** The first schedule required to be attached is a schedule of all assets held for investment purposes at the end of the plan year, aggregated and identified by issue, maturity date, rate of interest, collateral, par or maturity value, cost and current value, and, in the case of a loan, the payment schedule.

In column (a), place an asterisk (*) on the line of each identified person known to be a party-in-interest to the plan. In column (c), include any restriction on transferability of corporate securities. (Include lending of securities permitted under Prohibited Transactions Exemption 81-6.)

This schedule must be clearly labeled "Schedule H, line 4i—Schedule of Assets (Held At End of Year)."
The second schedule required to be attached is a schedule of investment assets that were both acquired and disposed of within the plan year. This schedule must be clearly labeled “Schedule H, line 4i—Schedule of Assets (Acquired and Disposed of Within Year).”

<table>
<thead>
<tr>
<th>(a)</th>
<th>Identity of issue, borrower, lessor, or similar party</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b)</td>
<td>Description of investment including maturity date, rate of interest, collateral, par, or maturity value</td>
</tr>
<tr>
<td>(c)</td>
<td>Cost</td>
</tr>
<tr>
<td>(d)</td>
<td>Current value</td>
</tr>
</tbody>
</table>

Notes: (1) Participant loans under an individual account plan with investment experience segregated for each account, that are made in accordance with 29 CFR 2550.408b–1 and that are secured solely by a portion of the participant’s vested accrued benefit, may be aggregated for reporting purposes in item 4i. Under identity of borrower enter “Participant loans,” under rate of interest enter the lowest rate and the highest rate charged during the plan year (e.g., 8%–10%), under the cost and proceeds columns enter zero, and under current value enter the total amount of these loans. (2) Column (d) cost information for the Schedule of Assets (Held At End of Year) and the column (c) cost of acquisitions information for the Schedule of Assets (Acquired and Disposed of Within Year) may be omitted when reporting investments of an individual account plan that a participant or beneficiary directed with respect to assets allocated to his or her account (including a negative election authorized under the terms of the plan). (3) Participant-directed brokerage account assets reported in the aggregate on line 1c(15) should be treated as one asset held for investment for purposes of the line 4i schedules, except investments in tangible personal property must continue to be reported as separate assets on the line 4i schedules.

* * *

Exhibit 3-4

Schedule of Reportable Transactions

Line 4j. Check “Yes” and attach to the Form 5500 the following schedule if the plan had any reportable transactions (See 29 CFR 2520.103-6 and the examples provided in the regulation). The schedule must use the format set forth below or a similar format. See 29 CFR 2520.103-11.

A reportable transaction includes:

1. A single transaction within the plan year in excess of 5% of the current value of the plan assets;

2. Any series of transactions with or in conjunction with the same person, involving property other than securities, which amount in the aggregate within the plan year (regardless of the category of asset and the gain or loss on any transaction) to more than 5% of the current value of plan assets;
3. Any transaction within the plan year involving securities of the same issue if within the plan year any series of transactions with respect to such securities amount in the aggregate to more than 5% of the current value of the plan assets; and

4. Any transaction within the plan year with respect to securities with, or in conjunction with, a person if any prior or subsequent single transaction within the plan year with such person, with respect to securities, exceeds 5% of the current value of plan assets.

The 5% figure is determined by comparing the current value of the transaction at the transaction date with the current value of the plan assets at the beginning of the plan year. If this is the initial plan year, you may use the current value of plan assets at the end of the plan year to determine the 5% figure.

If the assets of two or more plans are maintained in one trust, except as provided below, the plan’s allocable portion of the transactions of the trust shall be combined with the other transactions of the plan, if any, to determine which transactions (or series of transactions) are reportable (5%) transactions.

For investments in common/collective trusts, pooled separate accounts, 103-12 IEs and registered investment companies, determine the 5% figure by comparing the transaction date value of the acquisition and/or disposition of units of participation or shares in the entity with the current value of the plan assets at the beginning of the plan year. If the Schedule H is attached to a Form 5500 filed for a plan with all plan funds held in a master trust, check “No” on line 4j. Plans with assets in a master trust that have other transactions should determine the 5% figure by subtracting the current value of plan assets held in the master trust from the current value of all plan assets at the beginning of the plan year and check “Yes” or “No,” as appropriate. Do not include individual transactions of common/collective trusts, pooled separate accounts, master trust investment accounts, 103-12 IEs and registered investment companies in which this plan or DFE invests.

In the case of a purchase or sale of a security on the market, do not identify the person from whom purchased or to whom sold.

**Special rule for certain participant-directed transactions.** Transactions under an individual account plan that a participant or beneficiary directed with respect to assets allocated to his or her account (including a negative election authorized under the terms of the plan) should not be treated for purposes of line 4j as reportable transactions. The current value of all assets of the plan, including these participant-directed transactions, should be included in determining the 5% figure for all other transactions.

**Line 4j Schedule.** The schedule required to be attached is a schedule of reportable transactions that must be clearly labeled “Schedule H, line 4j—Schedule of Reportable Transactions.”

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
<th>(e)</th>
<th>(f)</th>
<th>(g)</th>
<th>(h)</th>
<th>(i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identity of party involved</td>
<td>Description of asset (include interest rate and maturity in case of a loan)</td>
<td>Purchase price</td>
<td>Selling price</td>
<td>Lease rental</td>
<td>Expense incurred with transaction</td>
<td>Cost of asset</td>
<td>Current value of asset on transaction date</td>
<td>Net gain or (loss)</td>
</tr>
</tbody>
</table>

* * *
### Exhibit 3-5

**Examples of Reportable Transactions**

<table>
<thead>
<tr>
<th>Description of Transaction</th>
<th>Reportable?</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Single transaction exceeding 5% of plan assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Plan A buys a security on the open market for a purchase price equal to 3% of plan assets.</td>
<td>No.</td>
<td>The transaction does not exceed 5% of plan assets.</td>
</tr>
<tr>
<td>B. Plan B buys real estate from an unrelated party for a price equal to 6% of plan assets.</td>
<td>Yes.</td>
<td>The transaction exceeds 5% of plan assets. Transactions involving securities or other property should be reported.</td>
</tr>
<tr>
<td>C. Plan C is repaid a mortgage loan made to an unrelated party in a previous year. The amount repaid equals 8% of plan assets at the beginning of the plan year.</td>
<td>Yes.</td>
<td>The transaction exceeds 5% of plan assets.</td>
</tr>
<tr>
<td>D. Plan D purchases mutual fund shares directly from the fund in an amount equal to 7% of plan assets. The amount of the plan's purchase was determined by investment elections made by participants in an individual account plan.</td>
<td>No.</td>
<td>Participant or beneficiary directed transactions under an individual account plan are not taken into account for purposes of preparing the schedule of reportable transactions, regardless of the size of the transaction. A transaction is considered directed by a participant or beneficiary if such participant or beneficiary authorized it.</td>
</tr>
<tr>
<td>E. Plan E cashes in a GIC (purchased in a previous year) with an insurance company and receives an amount equal to 6% of plan assets.</td>
<td>Yes.</td>
<td>The transaction exceeds 5% of plan assets.</td>
</tr>
<tr>
<td>F. Plan F receives a contribution from the plan sponsor equal to 5.5% of plan assets.</td>
<td>No.</td>
<td>While the transaction exceeds 5% of plan assets, it is not the intent of DOL that contributions from plan sponsors be reported as reportable transactions.</td>
</tr>
<tr>
<td>G. Plan G distributed 6% of its plan assets to a retired employee.</td>
<td>No.</td>
<td>While the distribution exceeded 5% of plan assets, it is not the intent of DOL that distributions be reported as reportable transactions.</td>
</tr>
<tr>
<td>H. Plan H paid a claims service fee for services rendered an amount equal to 8% of its plan assets.</td>
<td>No.</td>
<td>While the payment exceeded 5% of plan assets, it is not the intent of DOL that payments for services rendered be reported as reportable transactions.</td>
</tr>
</tbody>
</table>
II. A series of transactions with the same person involving property other than securities and aggregating to more than 5% of plan assets

A. Plan I buys a building from an unrelated party for a price equal to 4.5% of plan assets and later buys a computer from the same party for a price equal to 1% of plan assets.

Yes. Both transactions are reportable, since they are with the same person, involve property other than securities, and aggregate to more than 5% of plan assets.

B. Plan J buys a building from an unrelated party for a price equal to 4% of plan assets and later sells land to the same party for a price equal to 3% of plan assets.

Yes. Both transactions are reportable. Although the transactions net to 1% (4% purchase and 3% sale), their gross amount (7%) exceeds 5% of plan assets.

C. Plan K sells real estate to an unrelated party for an amount equal to 3.5% of plan assets and at the same time makes a mortgage loan on the property to the same party in an amount equal to 3% of plan assets.

Yes. Both transactions are reportable, since they are part of a series involving the same person, involve property other than securities, and aggregate to more than 5% of plan assets. This is example 3 from DOL Reg. 2520.1036(e).

D. Plan L buys a building from an unrelated party for an amount equal to 3% of plan assets and then buys securities from the same party for an amount equal to 3% of plan assets.

No. Neither transaction is reportable. The two transactions in the series with the same person do not both involve property other than securities. In addition, neither transaction is reportable under I as a single transaction exceeding 5% of plan assets because neither exceeds 5%.

III. Transactions in a series of securities transactions involving the same issue, if the series aggregates to more than 5% of plan assets

A. Plan M buys common stock of unrelated T Corp. for a price equal to 4% of plan assets and later buys preferred stock of T Corp. for a price equal to 3% of plan assets.

No. Neither transaction is reportable. The securities (common stock and preferred stock) are not of the same issue (even though they are of the same issuer). In addition, neither transaction is reportable under I as a single transaction exceeding 5% of plan assets because neither exceeds 5%.

B. Plan N sells common stock of unrelated U Corp. on the open market for a price that equals 4% of plan assets and later buys common stock of U Corp. directly from U Corp. for a price that equals 2% of plan assets.

Yes. Both transactions are reportable because they involve securities of the same issue and the gross value of the series aggregates to more than 5% of plan assets. Note that the transactions are reportable even though neither transaction alone exceeds 5%, and even though the net value of the 4% sale and 2% purchase is less than 5%.
IV. **Securities transactions with a person, if any preceding or subsequent single securities transaction with the same person exceeds 5% of plan assets**

<table>
<thead>
<tr>
<th>Description of Transaction</th>
<th>Reportable?</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Plan O buys V Corp. common stock from an unrelated party for a price that equals 1% of plan assets and later buys W Corp. common stock from the same party for a price that equals 6% of plan assets.</td>
<td>Yes.</td>
<td>Both transactions are reportable because they involve the same party and one of them exceeds 5% of plan assets. Note that the securities need not be of the same issue to be reportable if they involve the same party. Also note that even if the 6% transaction involved a different party, it (but not the 1% transaction) would still be reportable under I as a single transaction exceeding 5%.</td>
</tr>
<tr>
<td>B. Plan P buys X Corp. preferred stock from an unrelated party for a price that equals 4% of plan assets and later buys Y Corp. common stock from the same party for a price that equals 3% of plan assets.</td>
<td>No.</td>
<td>Neither transaction is reportable, even though they involve securities and the same person and aggregate to more than 5%, because neither single transaction exceeds 5%. In addition, the transactions are not reportable under III because they do not involve the same issue.</td>
</tr>
<tr>
<td>C. Plan Q buys unlisted stock of Z Corp. from Z Corp. for a price that equals 2% of plan assets and later buys more of the same stock from the same party for a price that equals 6% of plan assets.</td>
<td>Yes.</td>
<td>Both transactions are reportable because they involve securities and the same person, and one of them exceeds 5% of plan assets. Note that if the 6% transaction involved a different person, it (but not the 2% transaction) would still be reportable under I as a single transaction exceeding 5%.</td>
</tr>
<tr>
<td>D. Plan R buys AA Corp. common stock (listed on a national exchange) from a broker (acting as agent) for a price that equals 6% of plan assets and later buys more of the same stock from the same broker (still acting as agent) for a price that equals 2% of plan assets.</td>
<td>Yes and no.</td>
<td>The 6% transaction is reportable under I as a single transaction exceeding 5% of plan assets. The 2% transaction is not reportable under IV due to an exception in DOL Reg. 2520.103-6. That exception states that for the purposes of IV, a “person” does not include a registered broker/dealer acting as an agent in a transaction involving securities listed on a national securities exchange or quoted on NASDAQ. (Contrast this example with IV.C., where the stock is unlisted and the transaction does not involve a broker.)</td>
</tr>
</tbody>
</table>
### Description of Transaction

<table>
<thead>
<tr>
<th>Description of Transaction</th>
<th>Reportable?</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>E.</strong> Plan S buys a bank certificate of deposit with a six-month maturity from BB Bank for a price that equals 2% of plan assets and later buys another six-month certificate of deposit from the same bank for a price that equals 6% of plan assets.</td>
<td>Yes and no.</td>
<td>The 6% transaction is reportable under I as a single transaction exceeding 5% of plan assets. The 2% transaction is not reportable under IV due to an exception in DOL Reg. 2520.1036. That exception states that for the purposes of IV, a “security” does not include bank certificates of deposit with a maturity of not more than one year or any of the following items: 1. Debt obligations of the U.S. or any U.S. agency with a maturity of not more than one year. 2. Debt obligations of the U.S. or any U.S. agency with a maturity of more than one year if purchased or sold, under a repurchase agreement having a term of less than 91 days. 3. Interests issued by a company registered under the Investment Company Act of 1940. 4. Commercial paper with a maturity of not more than nine months if it is ranked in the highest rating category for commercial paper by at least two nationally recognized statistical rating services and is issued by a company required to file reports under Section 13 of the Securities Exchange Act of 1934. 5. Participations in a bank common or collective trust. 6. Participations in an insurance company pooled separate account.</td>
</tr>
</tbody>
</table>

**F.** Plan T purchases mutual fund shares directly from the fund in an amount equal to 6% of plan assets. Later in the year the plan purchases additional mutual fund shares directly from the fund in an amount equal to 2% of plan assets. | Yes and no. | The 6% is reportable under I because it exceeds 5% of plan assets. The 2% is not reportable because DOL Reg. 2520.1036 (b)(2)(ii) states that interest (shares) issued by a mutual fund are not securities for purposes of IV. |

### Note:

* All transactions in this exhibit are assumed to take place in the same plan year unless otherwise indicated. The value of a transaction is the current value at the date of transaction, normally the purchase or sales price. The value of plan assets means the current value of gross (total) plan assets at the beginning of the plan year in which the transaction takes place. See Exhibit 3-4 for instructions from Schedule H relating to the schedule of reportable transactions. Also see DOL Reg. 2520.1036, “Definition of Reportable Transaction for Annual Return/Report.”

* * *
Form 5500

Plan management may engage the auditor to prepare the Form 5500 and related schedules as a separate service. If the auditor prepares the Form 5500, he or she may want to obtain PPC’s 5500 Deskbook. The book discusses and illustrates completed Form 5500 and related schedules for retirement and welfare benefit plans. If the client prepares the form, the auditor may wish to recommend PPC’s 5500 Deskbook.

Auditor’s Responsibility for Other Information in Form 5500

Material Inconsistency. Whether or not the auditor prepares Form 5500, he or she has no responsibility to apply audit procedures to corroborate information in Form 5500 beyond the financial information identified in the auditor’s report. However, AEBP, Paragraph 12.32, imposes a SAS No. 8 (AU 550), Other Information in Documents Containing Audited Financial Statements, responsibility on the auditor for other information contained in Form 5500. Thus, the auditor should read the Form 5500 (including any related schedules) and consider whether other information in the form, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements (including the required supplemental schedules). The categorization and other differences between the audited financial statements and Schedule H of Form 5500 (discussed later in this lesson) would not be considered inconsistencies for purposes of applying SAS No. 8.

If the auditor concludes that there is a material inconsistency, he or she should determine whether the financial statements, the auditor’s report, or both, require revision. If the auditor concludes that they do not require revision, he or she should ask the client to revise the other information to eliminate the inconsistency. If the other information is not revised, the auditor should add an explanatory paragraph to the auditor’s report to describe the inconsistency, withhold the use of the auditor’s report in the document, or withdraw from the engagement.

Material Misstatement of Fact. If the reading of the other information in Form 5500 (and any related schedules) causes the auditor to believe that there is a material misstatement of fact that is not a material inconsistency, he or she should discuss the matter with the client and, if necessary, recommend that the client consult its legal counsel or other appropriate party for advice on the matter. If, after discussion, the auditor still believes there is a material misstatement, he or she should consider steps, such as notifying the plan administrator in writing of his or her views and consulting the audit firm’s own legal counsel on appropriate action to take.

Auditor’s Responsibility for Other Information in Electronic Sites

More and more companies and plans make information, including financial information, available to the general public via the Internet, electronic bulletin boards, and similar electronic means. The Audit Issues Task Force issued an interpretation of SAS No. 8 (AU 9550.16–18) which provides that electronic sites are merely a means of distributing information and are not “documents” as used in SAS No. 8. Thus, auditors do not have any responsibility to read information contained in electronic sites, or to consider whether the information is consistent with the client’s original documents.

Auditor’s Reports

The auditor should note that DOL regulations [Reg. 2520.103-1(b)(5)(iv)] state that the auditor’s report must disclose any matters to which the auditor takes exception, including any exceptions that are the result of DOL regulations and, if practical, the effect on the financial statements. AEBP, Paragraph 13.14, states that the auditor may consider emphasizing a departure from DOL requirements that is not also a GAAP departure in an explanatory paragraph of the auditor’s report. A paragraph should be added when applicable.

There is no explicit GAAS requirement to read Form 5500 before the auditor’s report is released (for example, when someone other than the auditor is preparing the Form 5500 and it has not yet been prepared), but best practices indicate that release of the auditor’s report be delayed until the Form 5500 is available and has been read. The Employee Benefit Plans Industry Developments—2007 (Audit Risk Alert) explains that the timing of the review of the Form 5500 may affect the dating of the audit report. It states as follows:

If the Form 5500 has not been prepared prior to release of the financial statements, the auditor should consider obtaining a draft of the Form 5500 to prevent differences from arising after the
report has been issued. If differences arise additional procedures may have to be performed and the report possibly reissued for reconciling items.

AEBP, Paragraph 12.35, states that if the auditor’s report, for whatever reason, is to be issued prior to the auditor’s reading and approval of the Form 5500, the auditor should inform the plan administrator that the auditor’s report should not be attached to the Form 5500 and filed without the approval of the auditor. Some auditors include such a statement in a letter (transmittal letter) that transmits the auditor’s report to the client.

If the report and financial statements are issued and the auditor subsequently discovers, by reading the Form 5500, differences in information requiring adjustment or disclosure in the financial statements, it may be necessary to recall and reissue the auditor’s report. AEBP, Paragraph 12.36, states that the auditor may consider reissuing his or her report, dual-dated with respect to any differences between the financial statements and the Form 5500 that are subsequently disclosed, as required, in the notes to the financial statements. If the differences represent a material inconsistency or misstatement of fact in the preparation of the Form 5500, the auditor should follow the guidance previously noted in this lesson.

**Dating the Auditor’s Report**

SAS No. 103, which amends SAS No. 1, *Codification of Auditing Standards and Procedures*, AU 530, “Dating of the Independent Auditor’s Report,” requires that the date of the auditor’s report should be no earlier than the date sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor needs to coordinate the following dates:

- Audit report date.
- Management representation letter date.
- Subsequent events evaluation footnote disclosure date.

AICPA Technical Practice Aid, *Auditor Responsibilities for Subsequent Events*, (TIS 8700.02) suggests that in order to coordinate the auditor’s report date, management representation letter date, and the subsequent events evaluation footnote disclosure date, the auditor may want to take the following steps:

- Discuss the dating requirements with plan management in advance of starting the audit.
- Include in the engagement letter a provision that plan management will not date the subsequent event note earlier than the date of their management representation letter and the date of the auditor’s report.

This process will generally result in the date plan management discloses as the date through which they have evaluated subsequent events being the same date as the auditor’s report.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Which of the following is accurate when the auditor assists in drafting the financial statements of the employee benefit plan?
   a. The audit firm assumes responsibility for the accuracy and information contained in the financial statements.
   b. If the auditor is involved in the preparation of the financial statements for the benefit plan, the auditor is no longer considered independent.
   c. The auditor’s association with the preparation of the benefit plan financial statements may signify a material weakness in the internal control structure.

26. Jim is completing supplemental schedules for the benefit plan audit of Greenhouse Productions. He had answered “yes” to the question about nonexempt transactions. What else is required of Jim to make sure his supplemental schedules are correct?
   a. A supplemental schedule discussed in the instructions to Schedule H should be completed.
   b. The applicable part of Schedule G should be completed.
   c. Jim should include supplemental schedules for the current and prior years containing nonexempt transactions.
   d. Only transactions exceeding 5% of the current value of plan assets should be included.

27. What is the employer’s responsibility for delinquent contributions to a benefit plan?
   a. If participant contributions are delinquent, they should be reported by the plan on Schedule G of Form 5500.
   b. Delinquent amounts only need to be reported on Form 5500 in the year in which they are delinquent.
   c. If employers do not have the funds to pay contributions to the plan, they are allowed an extension to keep the company viable and can use contributions as they see fit.
   d. Delinquent amounts from the employer are not satisfied until the contributions have been paid plus the lost earnings or profits from those contributions.

28. Which of the following is true about the supplemental schedules for benefit plans?
   a. The method for reporting investment gains and losses should be the same as the method used on Form 5500.
   b. Trustees provide investment information to be included in supplemental schedules on the GAAP basis to auditors.
   c. The audited financial statements and the supplemental schedules should reflect the same basis of accounting.
   d. No requirements are given on the filing of the supplement schedules for Form 5500, except that they must be attached to the report.
29. Schedule H, line 4i has been completed for the benefit plan for ABC Company. Which of the following would ABC Company have an issue with when they are filing the supplemental schedule?

a. The current value of the investments, along with the maturity date, rate of interest, collateral, par or maturity value and payment schedule is included in line 4i.

b. Participant loans were aggregated for reporting purposes of the form, even though they are under individual account plans and secured by vested accrued benefits.

c. A schedule of acquisitions and disposals for the plan year is attached to Schedule H.

d. Each individual that is a party-in-interest to the plan is identified on the schedule.

30. Which of the following would be considered a reportable transaction of a benefit plan on Form 5500?

a. The plan administrator for Teak Furnishing’s health plan purchases mutual fund shares directly from the fund equal to 4% of plan assets.

b. Sunshine Cleaning Company’s retirement benefit plan purchases the unlisted stock of Price Equity equal to 1% of plan assets in March. In September, it purchases an additional stock equal to 7% of plan assets.

c. The benefit plan for Regan Distributions owes a 6% of total plan assets claims service fee for claims for the year.

d. The welfare plan of Starfish Pool Products purchases securities on the open market to add to their investment portfolio equal to 2% of plan assets.

31. If the auditor determines that the information contained in the client’s Form 5500 and the financials statements are not consistent, what should he do?

a. If the inconsistency cannot be rectified, he should withhold the use of the auditor’s report.

b. This is not the auditor’s problem since the auditor is not responsible for the information contained in the Form 5500.

c. If the information is revised to make the two consistent, the auditor needs to add an explanatory paragraph to the report.

d. The auditor should contact legal counsel if the client is not willing to revise the two and make them consistent.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

25. Which of the following is accurate when the auditor assists in drafting the financial statements of the employee benefit plan? (Page 315)

   a. The audit firm assumes responsibility for the accuracy and information contained in the financial statements. [This answer is incorrect. Plan management must understand that if the auditor is involved in the drafting of the financial statements, it does not change the fact that plan management is still responsible for the financial statements and is expected to acknowledge that responsibility in the management representation letter.]

   b. If the auditor is involved in the preparation of the financial statements for the benefit plan, the auditor is no longer considered independent. [This answer is incorrect. The auditor can maintain their independence for the engagement if plan management agrees to accept responsibility for the audit and document this responsibility in the management representation letter. The auditor should be satisfied that plan management has the ability to do so and should discuss this with plan management so they understand the meaning and significance of acknowledging responsibility for the financial statements.]

   c. The auditor’s association with the preparation of the benefit plan financial statements may signify a material weakness in the internal control structure. [This answer is correct. Plan management must understand that the auditor’s involvement in financial statement preparation may represent a significant deficiency or material weakness in internal control that must be communicated in writing to those charged with governance according to SAS No. 112.]

26. Jim is completing supplemental schedules for the benefit plan audit of Greenhouse Productions. He had answered “yes” to the question about nonexempt transactions. What else is required of Jim to make sure his supplemental schedules are correct? (Page 316)

   a. A supplemental schedule discussed in the instructions to Schedule H should be completed. [This answer is incorrect. Schedule H is a consideration when the auditor has assets held for investment purposes or reportable transactions per the Form 5500.]

   b. The applicable part of Schedule G should be completed. [This answer is correct. According to the DOL and ERISA, if question 4d—Nonexempt Transactions is answered “yes,” Part III of Schedule G must be completed and attached to the Form 5500 and the financial statements.]

   c. Jim should include supplemental schedules for the current and prior years containing nonexempt transactions. [This answer is incorrect. While several supplemental schedules must accompany the audited financial statements for the current period and be reported on by the auditor, the supplemental schedules from the prior year should not be included per the Form 5500 instructions.]

   d. Only transactions exceeding 5% of the current value of plan assets should be included. [This answer is incorrect. This is not required of nonexempt transactions, but is required of reportable transactions on Form 5500. All nonexempt transactions have to be disclosed on Form 5500 for employee benefit plans.]

27. What is the employer’s responsibility for delinquent contributions to a benefit plan? (Exhibit 3-1)

   a. If participant contributions are delinquent, they should be reported by the plan on Schedule G of Form 5500. [This answer is incorrect. Delinquent participant contributions must be reported on Form 5500 by answering “yes” to question 4a of Schedule H or I, not Schedule G. The aggregate amount all of delinquent contributions should be entered.]

   b. Delinquent amounts only need to be reported on Form 5500 in the year in which they are delinquent. [This answer is incorrect. A plan should continue reporting all delinquent amounts in subsequent years, until the year the delinquent contributions have been fully corrected according to DOL regulations.]
c. If employers do not have the funds to pay contributions to the plan, they are allowed an extension to keep
the company viable and can use contributions as they see fit. [This answer is incorrect. Per DOL
regulations, employers that hold contributions beyond the time allowed commingled with their general
assets have engaged in a prohibited use of plan assets.]

d. Delinquent amounts from the employer are not satisfied until the contributions have been paid plus
the lost earnings or profits from those contributions. [This answer is correct. According to DOL
regulations, a plan has fully corrected delinquent contributions when all delinquent contributions
have been paid to the plan and the plan has been reimbursed for any lost earnings or profits on those
amounts. It is the employer’s responsibility to make these corrections.]

28. Which of the following is true about the supplemental schedules for benefit plans? (Page 319)

a. The method for reporting investment gains and losses should be the same as the method used on Form
5500. [This answer is incorrect. The supplemental schedules should report information on investment
gains and losses using GAAP, and not the method required for reporting such gains and losses in line 2b
of Schedule H of Form 5500 per ERISA and DOL.]

b. Trustees provide investment information to be included in supplemental schedules on the GAAP basis to
auditors. [This answer is incorrect. Trustees often provide information on plan assets that is not on the
GAAP basis. The information may be on the cash basis or may use the settlement date rather than the trade
date. The auditor would need to make adjustments to the information to put it on the GAAP basis.]

c. The audited financial statements and the supplemental schedules should reflect the same basis of
accounting. [This answer is correct. According to requirements by the DOL, the supplemental
schedules should be on the same basis of accounting as the audited financial statements.]

d. No requirements are given on the filing of the supplement schedules for Form 5500, except that they must
be attached to the report. [This answer is incorrect. There are very specific instructions on the content and
format of the supplemental schedules required by DOL regulations. They must be on the same size paper
as Form 5500, they must be attached to the Form 5500, the audited financial statements must include these
schedules and should be labeled or the filing could be rejected.]

29. Schedule H, line 4i has been completed for the benefit plan for ABC Company. Which of the following would
ABC Company have an issue with when they are filing the supplemental schedule? (Exhibit 3-3)

a. The current value of the investments, along with the maturity date, rate of interest, collateral, par or
maturity value and payment schedule is included in line 4i. [This answer is correct. All of these items
should be included in line 4i, but ABC Company must also include the cost of each asset held for
investment to be in compliance with the requirements of Form 5500.]

b. Participant loans were aggregated for reporting purposes of the form, even though they are under
individual account plans and secured by vested accrued benefits. [This answer is incorrect. Participant
loans under an individual account plan with investment experience segregated for each account, that are
made in accordance with 29 CFR 2550.408b-1 and that are secured solely by a portion of the participant’s
vested accrued benefit, may be aggregated for reporting purposes in item 4i per the instructions of Form
5500.]

c. A schedule of acquisitions and disposals for the plan year is attached to Schedule H. [This answer is
incorrect. ABC Company should attach a schedule of investment assets that were both acquired and
disposed of within the plan year. This schedule must be clearly labeled “Schedule H, line 4i—Schedule
of Assets (Acquired and Disposed of Within Year) and is a requirement of Form 5500.]

d. Each individual that is a party-in-interest to the plan is identified on the schedule. [This answer is incorrect.
Column (a) of Form 4i requires an asterisk to be placed on each line that identifies persons known to be
a party-in-interest to the plan to be in compliance with Form 5500.]
30. Which of the following would be considered a reportable transaction of a benefit plan on Form 5500? (Exhibit 3-5)

a. The plan administrator for Teak Furnishing’s health plan purchases mutual fund shares directly from the fund equal to 4% of plan assets. [This answer is incorrect. DOL Reg 2520.1036(b)(2)(ii) states that interest (shares) issued by a mutual fund are not securities for purposes of reportable transactions in Form 5500.]

b. Sunshine Cleaning Company’s retirement benefit plan purchases the unlisted stock of Price Equity equal to 1% of plan assets in March. In September, it purchases additional stock equal to 7% of plan assets. [This answer is correct. Both transactions are reportable according to DOL regulations because the transactions involve securities and the same company and one of the transactions exceeds 5% of plan assets.]

c. The benefit plan for Regan Distributions owes a 6% of total plan assets claims service fee for claims for the year. [This answer is incorrect. While the payment does exceed 5% of plan assets, it is not the intent of DOL that payments for services rendered be reported as reportable transactions.]

d. The welfare plan of Starfish Pool Products purchases securities on the open market to add to their investment portfolio equal to 2% of plan assets. [This answer is incorrect. This would not be considered a reportable transaction per the definition by the DOL because the transaction does not exceed 5% of the plan assets.]

31. If the auditor determines that the information contained in the client’s Form 5500 and the financial statements are not consistent, what should he do? (Page 331)

a. If the inconsistency cannot be rectified, he should withhold the use of the auditor’s report. [This answer is correct. If the information between the two reports is not revised by the client, the auditor has the option of withdrawing from the engagement to keep the firm safe from liability.]

b. This is not the auditor’s problem since the auditor is not responsible for the information contained in the Form 5500. [This answer is incorrect. While an auditor has no responsibility to apply audit procedures to corroborate information in Form 5500 beyond the financial information identified in the auditor’s report, if the auditor determines that the two contain material inconsistencies, he has to require a revision.]

c. If the information is revised to make the two consistent, the auditor needs to add an explanatory paragraph to the report. [This answer is incorrect. The auditor is not required to add an explanatory paragraph to the auditor’s report if the client revises the information to eliminate the inconsistencies between the two reports. He is required to add an explanatory paragraph to the auditor’s report if the client refuses to do any revisions to make the two consistent with each other.]

d. The auditor should contact legal counsel if the client is not willing to revise the two and make them consistent. [This answer is incorrect. The auditor does not need to involve legal counsel, even if the client is unwilling to resolve the consistency issue, unless the auditor considers the inconsistency a material misstatement.]
CLIENT COMMUNICATIONS

Communicating Internal Control Related Matters

SAS No. 115 (AU 325), Communicating Internal Control Related Matters Identified in an Audit, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies, which, in the auditor’s judgment, are significant deficiencies or material weaknesses, should be communicated in writing to management and those charged with governance.

SAS No. 115 establishes two unconditional requirements:

- The auditor should evaluate identified control deficiencies and determine whether, individually or in combination, they are significant deficiencies or material weaknesses.
- The auditor should communicate, in writing, to management and those charged with governance all significant deficiencies or material weaknesses identified during the audit, including those communicated in prior audits if they have not been corrected.

Definitions. SAS No. 115 contains the following definitions:

- **Control Deficiency.** A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

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

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

Examples of Deficiencies. A control deficiency may be either a deficiency in design or a deficiency in operation. A **deficiency in design** exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A **deficiency in operation** exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Exhibit 3-6 lists examples from SAS No. 115 for both deficiencies in design and deficiencies in operation. While SAS No. 115 distinguishes between the two types of control deficiencies, there is no requirement to indicate in the communication to management and those charged with governance which are deficiencies in design and which are deficiencies in operation. The examples in the exhibit may be control deficiencies, significant deficiencies, or material weaknesses.

Identifying Control Deficiencies. In a GAAS audit, an auditor is not required to perform procedures to identify deficiencies in internal control. However, an auditor may become aware of control deficiencies while performing audit procedures. SAS No. 115 (AU 325.04) notes that, during the course of an audit, any of the following might cause the auditor to become aware of a control deficiency:

- Obtaining an understanding of the plan’s internal control (including evaluating the design and implementation of controls).

- Assessing the risks of material misstatement of the financial statements, whether those risks would be caused by error or fraud.

- Communicating with management or others (including any internal auditors, governmental authorities, etc.).

- Performing further audit procedures to respond to assessed risks.
Exhibit 3-6
Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Deficiencies in the Design of Controls

- Inadequate design of internal control over financial statements.
- Inadequate design of a control over a significant account or process.
- Inadequate documentation of the internal control components.
- Insufficient control consciousness within the organization, e.g., the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (if those controls would be necessary for effective internal control over financial reporting).
- Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management lack the qualifications and training to fulfill their assigned functions (for example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements).
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.
- The absence of an internal process to report internal control deficiencies to management on a timely basis.

Failures in the Operation of Controls

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control requiring dual authorization for significant disbursements).
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. (This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness. Material weaknesses relating to controls over the safeguarding of assets only exist if controls to prevent or detect a material misstatement of the financial statements are ineffective.)
- Failure to reconcile significant accounts.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, expenses are consistently understated at the direction of management.
- Misrepresentation by the client to the auditor.
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor’s test of the sample, the desired level of confidence was not obtained.
**Evaluating Control Deficiencies.** Although there is no requirement to search for control deficiencies to report, the auditor should evaluate identified control deficiencies to determine if they are significant deficiencies or material weaknesses. Auditors should evaluate control deficiencies individually and in the aggregate by significant account balance, disclosure, and component of internal control. This is because multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

**Aggregation of Deficiencies.** Auditors should evaluate control deficiencies both individually and in the aggregate by significant account balance, disclosure, and component of internal control to determine whether they represent a significant deficiency or material weakness on an aggregate basis.

**Mitigating Effects of Compensating Controls.** An auditor may obtain evidence that a control does not operate effectively when performing substantive procedures or tests of the operating effectiveness of controls. For instance, the auditor might identify a misstatement that was not prevented, or detected and corrected by the control, which indicates that a control did not operate effectively. The auditor may become aware of the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or a material weakness. SAS No. 115 (AU 325.14) states that the auditor may consider (but is not required to consider) whether there are effective compensating controls that could prevent the identified deficiency from being considered a material weakness or a significant deficiency.

A compensating control is one that results in the prevention (by preventive controls) or detection (by detective controls) of a misstatement. For example, a deficient preventive control might be compensated for by an effective detective control that achieves the control objective to which the preventive control relates.

SAS No. 115 (AU 325.14) requires the auditor to test the operating effectiveness of a compensating control only when the auditor believes the control mitigates the severity of an identified deficiency. If the auditor tests the compensating control and finds that it is effective, the auditor should consider the extent to which it mitigates the identified deficiency. For instance, a control deficiency an auditor initially considered a material weakness might be mitigated to a significant deficiency by an effective compensating control; then again, the compensating control might mitigate it to a control deficiency. For a compensating control to effectively mitigate a deficiency that would otherwise be a significant deficiency or material weakness, the compensating control should operate at a level of precision that would prevent, or detect and correct, a material misstatement. The consideration of a compensating control should include an evaluation of its existence and effectiveness (i.e., the auditor would need to test the effectiveness of the compensating control to the extent that he or she believes is necessary). Regardless of the extent to which the compensating control mitigates the control deficiency, however, a compensating control can only mitigate—not eliminate—a control deficiency.

On the other hand, redundant controls can eliminate a control deficiency. Unlike compensating controls, redundant controls are controls that duplicate other controls and achieve the same objectives. Therefore, if a client has a control that is not properly designed and operating, but a redundant control achieves the same objective as the deficient control, the auditor can test the design and operating effectiveness of that control and, if found to be effective, conclude that there is no control deficiency.

**Qualitative Considerations.** When determining the severity of an identified deficiency, the auditor’s overall judgment may be influenced by qualitative as well as quantitative considerations. The consideration of qualitative factors may cause the auditor to conclude that the severity of a control deficiency is increased.

**Prudent Official Test.** SAS No. 115 (AU 325.16) requires auditors to consider whether prudent officials having knowledge of the same facts and circumstances would agree with the auditor’s conclusion that an identified deficiency is not a material weakness. In other words, would a prudent official, with knowledge of the facts and circumstances, other controls tested, and the likelihood and magnitude of potential misstatement, agree with the auditor’s conclusion that a deficiency is not a material weakness? Stated more simply, would a prudent official with knowledge of the same facts and circumstances agree with the auditor’s classification of the control deficiency?

Finally, it is important to understand that the prudent official test is used only to gauge whether the judged severity of a control deficiency should be increased—not to justify a decrease in the severity.
Can the Auditor Draft the Financial Statements? AICPA staff have indicated that some auditors may be misunderstanding important concepts underlying SAS No. 115. Among these misunderstandings is the belief that the auditor’s drafting of the financial statements automatically results in a material weakness. Asking the auditor to draft the financial statements does not cause a control deficiency. However, it may be the result of a control deficiency. The intent of SAS No. 115 is not to prevent auditors from drafting the client’s financial statements. Instead, the issue to be considered when determining if a significant deficiency or material weakness exists is whether the client is capable of preparing the financial statements and has the skills and competencies necessary to prevent, detect, and correct a material misstatement.

A system of internal control over financial reporting does not stop at the general ledger. It includes controls over financial statement preparation, including note disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent or detect a misstatement in the financial statements. If the client is not capable of drafting the financial statements and lacks the skills and competencies to prevent, detect, and correct a misstatement, the client has a control deficiency that is probably a material weakness. The auditor can still prepare the financial statements but the material weakness should be communicated to management and those charged with governance. The fact that the auditor drafts the financial statements may mean they are correct, but it does not eliminate the control deficiency.

Stated another way, an auditor cannot be considered part of the client’s internal control. Thus, controls over the financial statement preparation function that exist in the auditor’s firm cannot be considered. Only controls that the client has in place can be considered in determining whether there is a control deficiency and its severity. (However, a CPA firm other than the auditor’s firm can be part of the client’s internal control, and those controls could be considered.)

It is important for the client to know that even if the auditor drafts the financial statements and the related notes, the client remains responsible for them. The auditor should clearly communicate to management and those charged with governance that the financial statements are the responsibility of management. Further, management and those charged with governance need to be made aware of the possible consequences of not correcting control deficiencies.

Another way of looking at this issue is to consider whether the client has sufficient knowledge to identify a material misstatement in auditor-prepared financial statements. If the auditor gave financial statements to a client knowing that they contained material errors, would the client have controls in place that would detect those misstatements? If the answer to this question is “no,” then the client lacks the skills and competencies to prevent, detect, and correct a misstatement and, therefore, has a control deficiency that is probably a material weakness.

It is important to distinguish between the auditor’s responsibilities under the AICPA Ethics Rules and SAS No. 115. Ethics Rule 101 requires independence in performance of an audit. According to Ethics Interpretation 101-3, Performance of Nonattest Services, before auditors perform nonattest services, they should determine that the requirements of 101-3 have been met.

The determination of auditor independence is totally separate from the evaluation of whether there is a control deficiency. Even though the auditor can prepare financial statements and maintain independence under the ethics rules, there could be a control deficiency. It is important to note that there are two different levels of understanding of accounting and financial reporting required by SAS No. 115 and Interpretation 101-3. Under SAS No. 115, the issue to be considered is whether the client is capable of performing accounting functions and preparing the financial statements and has the skills and competencies necessary to prevent, detect, and correct a misstatement. Under Interpretation 101-3, the auditor may assist management in performing management functions or making management decisions if they meet certain criteria. Among those criteria, Interpretation 101-3 allows clients to designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee nonattest services. Possessing suitable skill, knowledge, or experience to oversee a service requires a lower level of technical knowledge than the competence criteria in SAS No. 115.

Under Ethics Interpretation 101-3, establishing and maintaining (or functioning as) the client’s internal controls would impair the auditor’s independence. However, proposing journal entries or preparing the client’s financial statements would not automatically impair independence. As a practical matter, small employee benefit plans typically view proposing journal entries and preparing financial statements as part of the audit, and, based on
implementation guidance published by the AICPA Professional Ethics Executive Committee (PEEC), best practices indicate that PEEC did not intend for Interpretation 101-3 to require viewing those services as separate from the audit. Thus, proposing journal entries and preparing financial statements in connection with an audit would not impair independence.

Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. There are many gray areas requiring professional judgment. Auditors cannot draw a hard line on what constitutes a significant deficiency or a material weakness. Instead, auditors must evaluate the facts and circumstances specific to each situation.

Communication Requirements. The auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to management and those charged with governance. The communication is best made by the report release date but, in any case, should be made within 60 days of that date. The report release date is defined in SAS No. 103, Audit Documentation, as the date that the auditor grants the entity permission to use the auditor’s report in connection with the financial statements. SAS Nos. 103 and 114 defines those charged with governance as the persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting and disclosure process. In an employee benefit plan, management and those charged with governance may be the same, for example, the named fiduciary, the plan sponsor, an officer of the plan sponsor, the sponsor’s board of directors, or a multiemployer plan’s board of trustees.

SAS No. 115 requires significant deficiencies and material weaknesses reported in prior years that still exist to be reported again. There should be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as “Significant Deficiencies Communicated in Prior Years.” Prior-year comments typically are presented after new comments. The communication may merely refer to the previously-issued communication and its date.

The auditor may orally communicate significant deficiencies and material weaknesses during the audit. These communications need not be in writing at the interim date. However, oral communications of significant deficiencies or material weaknesses ultimately should be communicated in writing to management and those charged with governance.

Reporting When There Are No Significant Deficiencies. SAS No. 115 (AU 325.25) precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication (i.e., the fact that the auditors did not identify any significant deficiencies might lead readers to believe that there are none, but since the auditors do not have a responsibility to specifically identify significant deficiencies, they could have overlooked them). Therefore, in an audit engagement where no significant deficiencies or material weaknesses were identified, no SAS No. 115 communication would be provided to the client.

If there are no significant deficiencies, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management. The form of communication is not subject to the requirements of SAS No. 115. Accordingly, auditors may want to include the deficiencies in a separate communication, such as a management letter.

Reporting When There Are No Material Weaknesses. The auditors’ communication of significant deficiencies may indicate that no material weaknesses were noted. That contrasts to the discussion on significant deficiencies, which states that auditors may not state that no significant deficiencies were noted. Thus, auditors may discuss the absence of material weaknesses but not the absence of significant deficiencies.

SAS No. 115 (AU 325.24) notes that management or those charged with governance may ask the auditor to issue a communication indicating that no material weaknesses were noted for submission to governmental authorities. Because SAS No. 115 specifically allows an auditor to provide a communication of no material weaknesses to a governmental authority, some believe that auditors are not permitted to provide such a communication to other third-party users. Auditors are cautioned to consult an attorney about the risks involved before agreeing to furnish such a communication to other third-party users.
Communication with Those Charged With Governance

SAS No. 114 (AU 380), The Auditor’s Communication With Those Charged With Governance, establishes the following unconditional communication responsibility:

The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor’s professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. (AU 380.05)

The term “those charged with governance” replaces references in prior SASs to the board of directors or audit committee, but is much broader in scope. It includes all “person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.” (AU 380.03)

SAS No. 114 applies in many situations because of its broad scope. For example, most small single-employer plans do not have an audit committee; however, the term “those charged with governance” would generally include other groups or individuals responsible for overseeing the plan and the auditor would be required to meet the communication mandate described above. According to AEBP, Paragraph 12.38, “those charged with governance” refers to “those with responsibility for overseeing the strategic direction of the plan and obligations related to the accountability of the plan, including overseeing the plan’s financial reporting process.” According to AEBP, Paragraph 5.06, “for a single-employer employee benefit plan the individual charged with governance may include the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the employee benefit committee, administrative committee, investment committee, plan administrator or responsible party. For a multiemployer plan those charged with governance will ordinarily be the board of trustees.”

The auditor should communicate the following broad categories of matters to those charged with governance:

- The auditor’s responsibilities under generally accepted auditing standards.
- An overview of the planned scope and timing of the audit.
- Significant findings from the audit.

Responsibilities Under GAAS. The auditor should communicate the following matters:

- The auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by the plan administrator with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with GAAP.
- The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
- The auditor should also consider communicating that the auditor is responsible for reading the Form 5500 and considering whether other information in the form, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.

The auditor may communicate these matters through the engagement letter or similar means as long as that communication is provided to those charged with governance. The auditor may simultaneously communicate other matters, such as the degree of responsibility assumed for errors or fraud, internal control, and similar matters.

Planned Scope and Timing of Audit. The objective of this aspect of the communication is to provide an overview of key aspects of scope and timing without compromising audit effectiveness. For example, the auditor would describe the use of the concept of materiality in planning and performing the audit, but not specific testing thresholds or amounts.

Significant Audit Findings. The auditor should communicate the following matters:

- Qualitative aspects of the plan’s significant accounting practices. The appropriateness of the accounting policies to the particular circumstances of the plan, management’s process for identifying and making
significant estimates, and the neutrality, consistency, and clarity of disclosures. If the auditor considers a significant accounting practice to be inappropriate, the auditor should explain why and request changes.

b. **Significant difficulties encountered during the audit.** Explicit and implicit restrictions imposed by management, including significant delays in providing required information, unavailability of expected information, an unnecessarily brief time to complete the audit, or unexpected effort to obtain sufficient, appropriate audit evidence.

c. **Uncorrected misstatements.** The effect that individual uncorrected misstatements from the current and prior period may have on the opinion, a request for their correction, and the implications of failing to correct, considering qualitative as well as quantitative factors.

d. **Disagreements with management.** Whether or not satisfactorily resolved, differences with management about application of accounting principles, audit scope, or reporting disclosures, and similar matters that individually or in the aggregate could be significant to the plan’s financial statements or the auditor’s report.

e. **Independence.** Circumstances or relationships that in the auditor’s professional judgment may reasonably be thought to bear on independence. (SAS No. 114 does not mandate this communication, but states the auditor “may determine” it is appropriate.)

The auditor should also communicate any other audit findings that, in the auditor’s judgment, would be significant and relevant to oversight of financial reporting.

In addition to the matters listed above, unless all those charged with governance are involved in managing the entity, the auditor also should communicate the following:

a. **Material corrected misstatements.** Misstatements brought to the attention of management as a result of auditing procedures.

b. **Representations requested from management.** This may be done by providing a copy of the written representations obtained from management.

c. **Management’s consultations with other accountants.** The auditor’s views about significant accounting or auditing matters that were the subject of consultation.

d. **Significant issues discussed, or subject to correspondence with, management.** According to AEBP, Paragraph 12.41, this includes “other significant findings or issues that the auditor believes are significant and relevant to those charged with governance.” This may include issues such as application of accounting principles and auditing standards; and business conditions, plans or strategies that may affect the risks of material misstatement.

The significant audit findings should be communicated in writing when the auditor believes that oral communication would not be adequate. When the communication is in writing, the auditor should indicate in writing, that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties. The communication should be on a sufficiently timely basis to permit appropriate action. The auditor should evaluate whether the two-way communication process with those charged with governance is adequate and, if it is not, consider the effects of the risks of material misstatements and the sufficiency and appropriateness of the audit evidence supporting the auditor’s opinion.

SAS No. 114 does not change the following communication requirements of other SASs:

a. SAS No. 54 (AU 317.17), *Illegal Acts by Clients*, to communicate with the audit committee, or others with equivalent authority and responsibility, illegal acts.

b. SAS No. 59 (AU 341.17), *An Entity’s Ability to Continue as a Going Concern*, the effects on the audit report and financial statement disclosures, as well as the nature of conditions and events identified, when the
auditor concludes there is a substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time.

c. SAS No. 99 (AU 316.22), Consideration of Fraud in a Financial Statement Audit, to inquire directly of the audit committee (or at least its chair) regarding its views on risks of fraud and knowledge of fraud or suspected fraud.

d. SAS No. 99 (AU 316.79), to communicate with those charged with governance all fraud involving senior management and any other fraud that causes a material misstatement of the financial statements.

e. SAS No. 112 (AU 325A.20), Communicating Internal Control Related Matters Identified in an Audit, to communicate in writing to management and those charged with governance control deficiencies that are considered significant deficiencies or material weakness. (Or, SAS No. 115 requirements if it is adopted early.)

Documentation of Communications. SAS No. 114 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the plan. When matters have been communicated in writing, the auditor should retain a copy of the communication. The engagement letters may be used to communicate planning matters, including the auditor’s responsibilities under GAAS and the planned scope and timing of the audit, as long as the letter is provided to those charged with governance.

Fraud and Illegal Acts

The auditor’s responsibility and procedures for identifying party-in-interest transactions and evaluating whether they are prohibited transactions were discussed previously. The auditor’s responsibility to evaluate the results of audit procedures and consider whether they lead the auditor to believe that an error or fraud may have occurred is discussed earlier in the lesson. SAS No. 54 (AU 317), Illegal Acts by Clients, imposes detection and communication responsibilities for illegal acts, that is, for violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. SAS No. 54 is the primary source of guidance with respect to the auditor’s consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with GAAS. However, PITF Practice Alert 2004-01, Illegal Acts, provides additional guidance to auditors on the extent of consideration of illegal acts in an audit. A copy of the Practice Alert may be obtained from the AICPA’s website at www.aicpa.org/download/auditsstd/pract_alert/pa_2004_1.pdf. SAS No. 54 imposes lesser responsibilities for detection of illegal acts having material but indirect effects on the determination of financial statement amounts (the auditor only need be aware of the possibility that they may have occurred) and establishes communication responsibilities for those acts.

Prohibited transactions are illegal acts. AEBP, Paragraph 11.13, imposes a SAS No. 54 responsibility for the detection of prohibited transactions.

When the auditor is confronted with a discrepancy between the accounting records and other evidential matter (for example, no supporting documentation or no apparent authorization for a transaction, or discovery of documents for transactions that are not recorded), the auditor needs to consider how and why they might have occurred and investigate further. If the investigation leads the auditor to believe there may have been fraud or an illegal act, including a prohibited transaction, he or she should:

a. Obtain an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and the auditor’s report, including the need for adjustments and for disclosure of illegal acts. (A prohibited transaction may give rise to a significant receivable because the fiduciary is liable to the plan for any losses the plan sustained, or profits the fiduciary gained, as a result of the breach of fiduciary duty.)

b. Consider the implications for other aspects of the audit, for example, reliance on management’s representations.

c. Discuss the matter and the need for any further investigation with an appropriate level of management.
d. Consult with the client’s legal counsel or another specialist on how ERISA or other laws apply to the circumstances and on the course of action the client should take.

In the rare event that management is not willing to follow sound legal advice about fraud or illegal acts, the auditor should seek the recommendation of a lawyer on his or her own legal responsibilities, including possible withdrawal from the engagement. The auditor would of course carefully document all communications related to the matter and its disposition.

**Communication about Fraud.** SAS No. 54 (AU 317) requires the auditor to be sure that the audit committee (or others with equivalent authority and responsibility such as the plan’s administrator, administrative committee, board of directors, or an officer of the plan sponsor) is adequately informed about any illegal acts, unless clearly inconsequential, that come to the auditor’s attention. If the auditor determines there is evidence that fraud may exist (even if the matter is inconsequential), SAS No. 99 (AU 316.79) requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. Auditors are also required to reach an understanding with those charged with governance about the nature and extent of communication about misappropriations committed by lower level employees. In the absence of such an agreement, the auditor should report all instances of fraud to both the appropriate level of management and to those charged with governance. Communications about possible fraud should be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

Both SAS No. 54 (AU 317) and SAS No. 99 (AU 316) state that the auditor ordinarily is not responsible for disclosing fraud or other illegal acts to parties other than senior management and those charged with governance. However, as discussed previously, the auditor must disclose all prohibited transactions of which he is aware in the required supplemental schedules of prohibited transactions.

**Communication about the Plan’s Ability to Continue as a Going Concern**

SAS No. 114 amended SAS No. 59, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*, to require the auditor to communicate with those charged with governance events or conditions that, when considered in the aggregate, indicate a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time. The auditor should communicate the following to those charged with governance (AU 341.17):

- The nature of the events or conditions identified.
- The possible effect on the financial statements and the adequacy of related disclosures in the financial statements.
- The effects on the auditor’s report.
SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Which of the following is defined as an insufficient control that is not designed to allow management or employees, as they complete their daily task, to identify errors in an appropriate time period?
   a. Material weakness.
   b. Significant deficiency.
   c. Control deficiency.

33. Which of the following would be considered a deficiency in the design of internal controls?
   a. Thompson Builders has not been able to reconcile the payroll bank account for the last eight months due to lack of staff. The company employs more than 1,000 people.
   b. Each accounting employee at Drymount Fabricators uses the same login ID to gain access to the accounting system of the company.
   c. SMB Distributions has a procedure in place that two executive members of the company have to sign all checks over $10,000. The CFO of the company is going out of town, so he signs five blank checks to allow accounting to take care of bills while he is gone.
   d. The accounting staff of Blue Foam, Inc. are each issued a laptop to complete their work. The IT procedures require all staff to take their laptop home each night, for safeguarding reasons. Many people lock their offices instead of taking their laptops home.

34. Which of the following is a test that can remove a control deficiency, but is also a repetitive test?
   a. Prudent Official Test.
   b. Compensating control.
   c. Redundant control.

35. Which of the following can be considered when determining a client’s internal control deficiencies?
   a. The auditor’s process for financial statement preparation for a client.
   b. Current, enforced controls that the client utilized when the financial statements were produced.
   c. The auditor’s firm’s internal control structure.

36. An auditor should determine how their responsibilities differ under Ethics Interpretation 101-3 and SAS No. 115. Which of the following is correct regarding the features of Ethics Interpretation 101-3?
   a. Ethics Interpretation 101-3 requires a higher level of competency criteria than SAS No. 115.
   b. If the auditor maintains independence in the audit, there should be no control deficiencies for the client.
   c. Ethics Interpretation 101-3 is concerned that the client has the skills and competencies necessary to distinguish, avert and ultimately, adjust financials for misstatements.
   d. Independence is mandatory when an auditor is executing an audit under Ethics Interpretation 101-3.
37. Ken was engaged to audit the employee benefit plan financial statements of Blue Jay Autos. He is working on communicating the significant deficiencies and material weaknesses that his staff identified during the audit to management. Ken released the audit report on May 1, but is planning on communicating to management the deficiencies and weaknesses on June 1, although he has already had numerous communications with the audit committee and president, who is not the plan sponsor, about what the audit team identified. He is putting together a written report and including all the deficiencies and weaknesses that were reported in prior years and still exist. What part of the required communications about significant deficiencies and material weaknesses has Ken missed?

a. He has not submitted a written report to management detailing the significant deficiencies and material weaknesses.
b. Ken did not issue the information on a timely basis, since he did not report it with the deliverance of the audit report.
c. He should not have included prior significant deficiencies and material weaknesses in the report since they were previously communicated.
d. Ken did not communicate the significant deficiencies and material weaknesses to the appropriate people in the organization.

38. Stacy is communicating the audit information of a multiemployer benefit plan to the board of trustees. The board of trustees is not involved in the day to day managing of the companies that participate in the plan. Which of the following should Stacy make sure she communicates to the board of trustees?

a. Any misstatements identified during the course of the audit that management chose not to correct.
b. Consultations with accountants not on the audit team that were requested by the management of the company.
c. Disputes with management about significant disclosures to include in the financial statements.
d. Restrictions placed on the audit team by the management of the company that created a significant difficulty in completing the audit.

39. Which of the following is true regarding the application of SAS No. 114 to audits of employee benefit plans?

a. All matters that have been communicated to those charged with governance must be documented.
b. The issue of whether the benefit plan will be able to continue as a going concern must be addressed.
c. The effectiveness of the internal control structure in preventing significant deficiencies and material weaknesses must be communicated.
d. How any fraud committed against the benefit plan affected the financial statements must be considered.

40. Katie is working on the audit of the employee benefit plan of WoodChip Furniture. She suspects that the plan administrator has committed fraud. Which of the following is Katie not required to do based on the discovery of fraud?

a. Determine if the fraud changes whether or not Katie can trust the provided management representations.
b. Meet with the audit committee and the appropriate level of management to discuss the suspected fraud.
c. Immediately withdraw from the engagement and seek legal counsel.
d. Investigate the matter to determine the possible consequences to the financial statements.
SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. (References are in parentheses.)

32. Which of the following is defined as an insufficient control that is not designed to allow management or employees, as they complete their daily task, to identify errors in an appropriate time period? (Page 338)

a. Material weakness. [This answer is incorrect. A material weakness is a deficiency, or combination of efficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis per SAS No. 115.]

b. Significant deficiency. [This answer is incorrect. As stated in SAS No. 115, a significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.]

c. Control deficiency. [This answer is correct. According to SAS No. 115, a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.]

33. Which of the following would be considered a deficiency in the design of internal controls? (Exhibit 3-6)

a. Thompson Builders has not been able to reconcile the payroll bank account for the last eight months due to lack of staff. The company employs more than 1,000 people. [This answer is incorrect. While not reconciling a significant account is an internal control deficiency, it is a failure to follow operation of controls, not a deficiency in the design of controls. The company could have the procedures in place for bank reconciliations, but the staff at Thompson Builders is not following the procedures.]

b. Each accounting employee at Drymount Fabricators uses the same login ID to gain access to the accounting system of the company. [This answer is correct. By using a common login ID for all employees, the company has an absent or inadequate control over the safeguarding of assets, which includes the necessary controls for internal control to be effective over financial reporting. All employees would have access to the same information and could modify information that they are not responsible for reporting for the company.]

c. SMB Distributions has a procedure in place that two executive members of the company have to sign all checks over $10,000. The CFO of the company is going out of town, so he signs five blank checks to allow accounting to take care of bills while he is gone. [This answer is incorrect. While there is an internal control procedure in place, the CFO is failing to operate the controls by overriding them, so this is not a deficiency in the design of the internal controls.]

d. The accounting staff of Blue Foam, Inc. are each issued a laptop to complete their work. The IT procedures require all staff to take their laptop home each night, for safeguarding reasons. Many people lock their offices instead of taking their laptops home. [This answer is incorrect. IT has put a procedure in place for the safeguarding of the laptops, to keep information and assets safe from theft but also to keep them safe from any disasters in the building, such as a fire. Since the employees are not following the controls to keep the laptops safe as dictated by the IT internal controls, they are failing in the operation of controls.]
34. Which of the following is a test that can remove a control deficiency, but is also a repetitive test? (Page 340)

a. Prudent Official Test. [This answer is incorrect. SAS No. 115 (AU 325.16) requires auditors to consider whether prudent officials having knowledge of the same facts and circumstances would agree with the auditor’s conclusion that an identified deficiency is not a material weakness.]

b. Compensating control. [This answer is incorrect. According SAS No. 115, a compensating control is one that results in the prevention or detection of a misstatement that is material or more than inconsequential.]

c. Redundant control. [This answer is correct. Redundant controls can eliminate a control deficiency, but the controls are duplications of other controls and achieve the same objectives according to SAS No. 115.]

35. Which of the following can be considered when determining a client’s internal control deficiencies? (Page 341)

a. The auditor’s process for financial statement preparation for a client. [This answer is incorrect. The auditor cannot be considered part of the client’s internal control since he is not there on a day to day basis evaluating the internal controls. Having the auditor draft the financial statements does not eliminate the control deficiencies of the client’s internal control structure.]

b. Current, enforced controls that the client utilized when the financial statements were produced. [This answer is correct. Only controls that the client has in place can be considered in determining whether there is a control deficiency and its severity since those are the controls that applied to the time period for which the financial statements are produced.]

c. The auditor’s firm’s internal control structure. [This answer is incorrect. Controls over the financial statement preparation function that exist in the auditor’s firm or the auditor’s firm’s internal control structure cannot be considered as part of the client’s internal control structure. These would define the firm’s internal control structure, since it would be the procedures applied on a daily basis by the auditing firm, but it does not define the client’s internal control structure.]

36. An auditor should determine how their responsibilities differ under Ethics Interpretation 101-3 and SAS No. 115. Which of the following is correct regarding the features of Ethics Interpretation 101-3? (Page 341)

a. Ethics Interpretation 101-3 requires a higher level of competency criteria than SAS No. 115. [This answer is incorrect. Interpretation 101-3 allows clients to designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee nonattest services. Possessing suitable skill, knowledge, or experience to oversee a service requires a lower level of technical knowledge than the competency criteria in SAS No. 115.]

b. If the auditor maintains independence in the audit, there should be no control deficiencies for the client. [This answer is incorrect. The determination of auditor independence is totally separate from the evaluation of whether there is a control deficiency. Even though the auditor can prepare financial statements and maintain independence under Ethics Interpretation 101-3, a control deficiency can still exist.]

c. Ethics Interpretation 101-3 is concerned that the client has the skills and competencies necessary to distinguish, avert and ultimately, adjust financials for misstatements. [This answer is incorrect. Under SAS No. 115, the issue to be considered is whether the client is capable of performing the accounting functions and preparing the financial statements and has the skills and competencies necessary to prevent, detect and correct a misstatement, not Ethics Interpretation 101-3.]

d. Independence is mandatory when an auditor is executing an audit under Ethics Interpretation 101-3. [This answer is correct. Ethics Rule 101 requires independence in performance of an audit, while SAS No. 115 asks whether the client is capable of preparing the financial statements.]
37. Ken was engaged to audit the employee benefit plan financial statements of Blue Jay Autos. He is working on communicating the significant deficiencies and material weaknesses that his staff identified during the audit to management. Ken released the audit report on May 1, but is planning on communicating to management the deficiencies and weaknesses on June 1, although he has already had numerous communications with the audit committee and president, who is not the plan sponsor, about what the audit team identified. He is putting together a written report and including all the deficiencies and weaknesses that were reported in prior years and still exist. What part of the required communications about significant deficiencies and material weaknesses has Ken missed? (Page 342)

a. He has not submitted a written report to management detailing the significant deficiencies and material weaknesses. [This answer is incorrect. The auditor may orally communicate significant deficiencies and material weaknesses during the audit. These communications need not be in writing at the interim date, but ultimately should be communicated in writing to management and those charged with governance.]

b. Ken did not issue the information on a timely basis, since he did not report it with the deliverance of the audit report. [This answer is incorrect. The communication on significant deficiencies and material weaknesses is best made by the report release date, but should be made within 60 days of that date. Although Ken released his audit report on May 1 and did not communicate until June 1, he is well within the 60 day time period.]

c. He should not have included prior significant deficiencies and material weaknesses in the report since they were previously communicated. [This answer is incorrect. SAS No. 115 requires significant deficiencies and material weaknesses reported in prior years that still exist to be reported again. So, Ken adhered to the requirements of SAS No. 115 by including those in his report.]

d. Ken did not communicate the significant deficiencies and material weaknesses to the appropriate people in the organization. [This answer is correct. Although Ken did inform management and the audit committee of the deficiencies and weaknesses, they are required to be communicated in writing to management and those charged with governance. SAS Nos. 103 and 114 defines those charged with governance as the persons responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. In an employee benefit plan, those charged with governance are, for example, the named fiduciary, the plan sponsor, an officer of the plan sponsor, the sponsor's board of directors, or a multiemployer plan's board of trustees. Ken has notified the audit committee and the president, who is not the plan sponsor, so he has not fulfilled this requirement.]

38. Stacy is communicating the audit information of a multiemployer benefit plan to the board of trustees. The board of trustees is not involved in the day to day managing of the companies that participate in the plan. Which of the following should Stacy make sure she communicates to the board of trustees? (Page 344)

a. Any misstatements identified during the course of the audit that management chose not to correct. [This answer is incorrect. While any uncorrected misstatements should be communicated to those charged with governance, it is not an element that should specifically be included for a group not included in the daily management of the company. All parties should be privy to this information since it can have an effect on the issued opinion of the audit.]

b. Consultations with accountants not on the audit team that were requested by the management of the company. [This answer is correct. If management consulted with accountants who were not on the audit team, this should be communicated to parties charged with governance, along with their findings and any information provided to management about their accounting policies and financial statements.]
c. Disputes with management about significant disclosures to include in the financial statements. [This answer is incorrect. Any disagreements with management, whether or not satisfactorily resolved, differences with management about application of accounting principles, audit scope, or reporting disclosures, and similar matters that individually or in the aggregate could be significant to the plan’s financial statements or the auditor’s report should be communicated to all parties charged with governance. This would not be specific to a party that was not involved in the daily operations of a company.]

d. Restrictions placed on the audit team by the management of the company that created a significant difficulty in completing the audit. [This answer is incorrect. Significant difficulties encountered during the audit, such as explicit or implicit restrictions imposed by management should be communicated to all parties charged with governance and would not be an additional communication required by the auditor to those not engaged in the daily management of the company.]

39. Which of the following is true regarding the application of SAS No. 114 to audits of employee benefit plans? (Page 345)

a. All matters that have been communicated to those charged with governance must be documented. [This answer is correct. SAS No. 114 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the plan. When matters have been communicated in writing, the auditor should retain a copy of the communication.]

b. The issue of whether the benefit plan will be able to continue as a going concern must be addressed. [This answer is incorrect. SAS No. 59 rather than SAS No. 114, addresses an entity’s ability to continue as a going concern, the effects on the audit report and financial statement disclosures, as well as the nature of the conditions and events identified, when the auditor concludes there is a substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time.]

c. The effectiveness of the internal control structure in preventing significant deficiencies and material weaknesses must be communicated. [This answer is incorrect. The issues of communicating internal control related matters identified in an audit is the purpose of SAS No. 115, not SAS No. 114. It includes how to communicate in writing to management and those charged with governance, control deficiencies that are considered significant deficiencies and material weaknesses.]

d. How any fraud committed against the benefit plan affected the financial statements must be considered. [This answer is incorrect. The consideration of fraud in the financial statement audit of the benefit plan is addressed by SAS No. 99, not SAS No. 114. SAS No. 99 includes its views on risks of fraud and knowledge of fraud or suspected fraud.]

40. Katie is working on the audit of the employee benefit plan of WoodChip Furniture. She suspects that the plan administrator has committed fraud. Which of the following is Katie not required to do based on the discovery of fraud? (Page 345)

a. Determine if the fraud changes whether or not Katie can trust the provided management representations. [This answer is incorrect. Katie should consider the implications for other aspects of the audit, for example, reliance on management’s representations, especially if these representations were provided by the plan administrator that is suspected of fraud. The plan administrator could have provided information to try and hide the fraud from the audit team.]

b. Meet with the audit committee and the appropriate level of management to discuss the suspected fraud. [This answer is incorrect. Under SAS No. 54, one of Katie’s responsibilities is to discuss the suspected fraud and the need for any further investigation with an appropriate level of management so that plans can be made on how it should be dealt with inside of the organization.]
c. Immediately withdraw from the engagement and seek legal counsel. [This answer is correct. SAS No. 54 does not require the auditor to withdraw from the engagement. Numerous other steps can be completed to obtain an understanding of the committed fraud and how it impacts the financial statements that Katie is auditing. In the rare event that management is not willing to follow the legal advice about fraud or illegal acts, the auditor should seek the recommendation of a lawyer on his or her own legal responsibilities, including possible withdrawal from the engagement.]

d. Investigate the matter to determine the possible consequences to the financial statements. [This answer is incorrect. Katie should obtain an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements, including the need for adjustments and for disclosure of illegal acts since this could change the outcome of the opinion on the audit.]
EXAMINATION FOR CPE CREDIT
Lesson 3 (EBPTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

25. Schedule H of IRS Form 5500 represents financial statements for employee benefit plans. Form 5500 must be supplemented by separate financial statements, if the auditor uses them to form his final opinion on the benefit plan. DOL regulations require that any variances from GAAP that are included in the notes to the separate financial statements clarify any departures from GAAP. Which of the following is a difference often seen in the Form 5500?
   a. Withdrawal liabilities should be recorded for GAAP, but not on Form 5500.
   b. Property should be valued at cost on Form 5500 versus fair value for GAAP.
   c. Form 5500 often uses a different method for calculating realized gains and losses on assets.
   d. Do not select this answer choice.

26. Which of the following is not a note disclosure required by DOL regulations in the financial statements?
   a. A description of the employee benefit plan.
   b. Management’s refusal to provide a management representation letter.
   c. Any loss contingencies related to the employee benefit plan.
   d. Whether the plan has acquired a tax determination letter from the IRS.

27. Travis is completing Schedule H of Form 5500 on assets held for investment purposes. He is trying to determine if an investment should be included on the schedule. Which of the following would prevent the asset from inclusion on Line 4i of Schedule H?
   a. The asset is part of a collective trust and was purchased during the plan year.
   b. It is a debt obligation of a U.S. agency and purchased and sold during the year.
   c. The asset was held by the plan on the last day of the plan year.
   d. The asset was included in the schedule of reportable transactions on line 4j.

28. Which of the following would be considered a reportable transaction and need to be included on line 4j of Schedule H?
   a. The plan administrator purchased real estate from an unrelated party equal to 3.5% of plan assets. Earlier in the year, he had purchased securities equal to 4% of plan assets from the same party.
   b. The health and welfare plan for High Quality Construction purchased mutual fund shares directly from the fund. The shares are equal to 10% of plan assets.
   c. The employee benefit plan for SnowStuff Inc. cashed in a Guaranteed Investment Contract (GIC) with an insurance company and received a distribution equal to 8% of total plan assets.
   d. In February, the plan administrator of Quick Coat Distributors purchased common stock of MLB, Inc. equal to 4% of total plan assets. In July, he bought preferred stock of MLB, Inc. equal to 3% of total plan assets.
29. If an audit firm audits the employee benefit plan of a client, it cannot prepare the Form 5500 for the client due to independence issues.
   a. True.
   b. False.
   c. Do not select this answer choice.
   d. Do not select this answer choice.

30. Which of the following is accurate regarding the issuance of the auditor’s report?
   a. If DOL regulations produce an exception for the auditor, the auditor’s report should disclose the matter.
   b. The auditor is required to read and agree with the Form 5500 before issuing the auditor’s report.
   c. The auditor’s report should always be attached to the Form 5500 when it is filed.
   d. Do not select this answer choice.

31. Which of the following is not an event that would provide assurance that sufficient appropriate audit evidence has been obtained to support the opinion?
   a. Accountability for the financial statements has been taken by the management of the company.
   b. The audit field work is finished and the workpapers for the audit are in order.
   c. A complete review of the audit work has been conducted by the audit partner.
   d. The preparation of the financial statements, including disclosures, has been completed.

32. Which of the following is a requirement of SAS No. 115?
   a. All control deficiencies found during the current audit should be communicated to management and a plan put in place to correct the deficiencies.
   b. Each individual significant deficiency should be addressed by the audit team and explained to management as it is discovered.
   c. Management should be informed, in writing of all significant deficiencies or material weaknesses that the audit team discovered in the course of the audit.
   d. Material weaknesses found in the internal control structure are the only concern of SAS No. 115.

33. Which of the following is a failure in the operation of internal controls?
   a. Red Window Products has internal control policies that were developed about 10 years ago. Due to staffing constraints, the company reviews the policies and procedures every three years. It usually takes three months to complete the review and six more months to accumulate the results.
   b. The CFO of Monkey Wrench Industries has asked the accounting staff to hold all bills for the month of December, in hopes of decreasing expenses for the company for the year so that he might be able to meet projections and obtain his yearly bonus.
   c. Management should be informed, in writing of all significant deficiencies or material weaknesses that the audit team discovered in the course of the audit.
   d. The CFO and controller of Green Parrot Drinks and Things both review the financial statements each month, but they do not review the journal entries prepared by the accounting staff or tie back totals to reports. They expect this information to be done before the financials are given to them.
34. SAS No. 115 does require auditors to assess the internal control structure of a company for inadequacies, but they do not need to aggregate the problems. Each issue should be considered individually.
   
a. True.
b. False.
c. Do not select this answer choice.
d. Do not select this answer choice.
35. According to the AICPA, what is the purpose of SAS No. 115?
   
a. To determine if the client has the skills to prepare financial statements and recognize and prevent material misstatements.
b. To communicate that if the auditor drafts the financial statements for the client, it automatically causes a material weakness.
c. To discourage the auditors from selling financial statement preparation to their clients.
d. To encourage a client to prepare the note disclosures that accompany the financial statements and detect any deficiencies in their preparation.
36. Under Ethics Interpretation 101-3, which of the following tasks would impair the auditor’s judgment, if performed?
   
a. Recommending adjusting journal entries to a client during an audit.
b. Producing the financial statements of a client that is being audited.
c. Creating a client’s internal controls.
d. Do not select this answer choice.
37. Which of the following would be appropriate communication for an audit that contained no significant deficiencies or no material weaknesses?
   
a. No significant deficiencies should be communicated, but if there are not material weaknesses, it should not be communicated.
b. If there are no significant deficiencies, there cannot be any control deficiencies, therefore the auditor will have nothing to communicate.
c. If no significant deficiencies are identified in the duration of the audit, their absence may be communicated.
d. If no material weaknesses are identified for the duration of the audit, their absence may be communicated.
38. Which of the following would be someone who is charged with governance in a multiemployer benefit plan?
   
a. Board of trustees.
b. President of the company.
c. Audit committee of the company.
d. CFO of the company.
39. Which of the following would not be an appropriate communication for an audit completed under GAAS?

   a. The auditor will read the Form 5500 and decide if it is materially consistent with the financial statements of the benefit plan.

   b. By completing the audit of the benefit plan, the auditor has assumed responsibility for the financial statements of the plan.

   c. The auditor will form and express an opinion on the financial statements of the benefit plan, completed in conformity with GAAP.

   d. The auditor prepares an engagement letter that conveys the degree of responsibility to detect errors or fraud in the audit of the employee benefit plan.

40. An auditor is required to disclose all illegal acts to the appropriate law enforcement agency when they disclose the information to senior management and the audit committee of the entity that is being audited.

   a. True.

   b. False.

   c. Do not select this answer choice.

   d. Do not select this answer choice.
GLOSSARY

Analytical procedures: A set of audit procedures that examine the relationships between financial and nonfinancial data.

Audit differences: Any differences noted between the accounting records and the evidence obtained during the audit, other than closing entries.

Contingency: An event or condition that may occur in the future but that cannot currently be predicted. It has an uncertain outcome. The outcome of that event will change an existing condition or resolve a current uncertainty. A contingency is classified as probable, reasonably possible, or remote.

Control deficiency: Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Deficiency in design: Exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

Deficiency in operation: When a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Fraud: The crime of deliberately deceiving another in order to cause harm. The key to fraud is the intent to cause injury.

Going concern: The accounting assumption that maintains that an entity will remain in business at least for one year in the absence of information to the contrary. Such information may include the entity’s ability to meet its obligations when due without disposing of assets outside the normal course of business, restructuring of debt, and so forth.

Internal control: An organization’s practices, policies, and procedures to safeguard its assets, detect and prevent errors and irregularities, check the accuracy and reliability of accounting information, promote operational efficiency, and ensure that such management practices are properly adhered to.

Known misstatement: A specific misstatement that the auditor identifies by performing audit procedures. They arise from the incorrect selection or misapplication of accounting principles or misstatements of facts identified.

Likely misstatement: Misstatements that (1) arise from differences between judgments made by management and the auditor about accounting estimates that the auditor believes are unreasonable or inappropriate, and (2) the auditor deems likely to exist resulting from an extrapolation from audit evidence obtained.

Management representation letter: A written representation from management that affirms the following:

- Management acknowledgment of primary responsibility for the financial statements and disclosures.
- The completeness of minutes of stockholders, directors, and committee meetings provided to the auditor.
- All financial records and related data have been made available to the auditor.
- No fraud involving management or employees is known.

Materiality: The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Material weakness: A deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
**Parties-in-interest:** Person who has the right to do something. Only the "party in interest" can file a lawsuit. As related to the Employee Retirement Income Security Act (ERISA) it is a person who provides some service to a pension or employee benefit plan. This service could be as an investment advisor, dealer or broker who makes purchases, underwriter, or advice on a sale or lease. In bankruptcy proceedings, the party in interest is one whose monetary interest is directly affected by the bankruptcy proceeding.

**Prohibited Transaction:** A fiduciary with respect to a Plan shall not cause the Plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect dealing with a party-in-interest, such as the following:

- Sale, exchange, or lease of any property
- Loan of money or other extension of credit
- Furnishing of goods, services, or facilities
- Transfer to or use by, for the benefit of, a party-in-interest of any assets of the Plan
- Acquisition, on behalf of the Plan, of any employer security or employer real property in violation of a 10% limit

**Redundant controls:** Controls that duplicate other controls and achieve the same objectives.

**Related party:** Management, owners, family members of owners or management, affiliates, or any party that "can significantly influence the management or operating policies" such that the entity might be "prevented from fully pursuing its separate interests."

**Reportable transaction:** Includes: (1) a single transaction within the plan year in excess of 5% of the current value of the plan assets; (2) any series of transactions with or in conjunction with the same person, involving property other than securities, which amount in the aggregate within the plan year to more than 5% of the current value of plan assets; (3) any transaction within the plan year involving securities of the same issue if within the plan year any series of transactions with respect to such securities amount in the aggregate to more than 5% of the current value of the plan assets; and (4) any transaction within the plan year with respect to securities with, or in conjunction with, a person if any prior or subsequent single transaction within the plan year with such person, with respect to securities, exceeds 5% of the current value of plan assets.

**Risk assessment:** One of the five components of internal control and the second level of the COSO pyramid depicting the structure of internal control. It is the identification and analysis of the risks that an entity faces in achieving its objectives and the determination of how those risks will be managed. All entities face risks from both internal and external sources. To be able to perform risk assessment, the entity must have established its objectives.

**Significant deficiency:** A control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control.

**Subsequent events:** An event occurring after the balance sheet date but prior to the issuance of the auditor’s report, which has a material effect on the financial statements and therefore requires adjustment or disclosure in the statements.

**Substantive procedures:** Tests of transaction details and account balances and analytical procedures performed to detect material misstatements in the account balances, transaction class, and disclosure components of the financial statements. These tests are used to test financial statement assertions.

**Supplemental information:** Financial information outside the basic financial statements that may or may not be required by GAAP.
**Trivial misstatement:** Amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

**Valuation:** The management assertion that all assets, liabilities, revenues, and expenses have been included in the financial statements at the proper amount.
INDEX

ACCOUNTING ESTIMATES ........................................ 300

ACCOUNTING STANDARDS
- Authoritative literature
  - AICPA Statement of Position No. 94-6 on disclosure of certain significant risks and uncertainties ............ 255
- Defined benefit retirement plan
  - AICPA Statement of Position No. 94-6 on disclosure of certain significant risks and uncertainties ............ 255
- Defined contribution retirement plan
  - AICPA Statement of Position No. 94-6 on disclosure of certain significant risks and uncertainties ............ 255
- Health and welfare benefit plan
  - AICPA Statement of Position No. 94-6 on disclosure of certain significant risks and uncertainties ............ 255
- SOP 94-6 risks and uncertainties ............................ 255
- Certain significant estimates ............................... 256
- Vulnerability resulting from concentrations ................ 256

ANALYTICAL PROCEDURES
- Review stage of audit ........................................ 291

AUDITOR'S REPORTS
- Dating the auditor's report ................................ 332
- Departure from DOL requirement ........................... 331
- DOL requirements for auditor's reports .................... 331
- Emphasis of a matter paragraph ............................ 331

AUTHORITATIVE LITERATURE
- Accounting literature
  - AICPA Statement of Position No. 94-6 on disclosure of certain significant risks and uncertainties ............ 255

C

COMMITMENTS AND CONTINGENCIES
- Audit procedures ............................................ 250, 251
- Legal representation letter ................................ 253
- Content of the letter ....................................... 253
- Evaluating lawyers' responses .............................. 254
- Plan tax status
  - Auditor's responsibility for plan tax status .......... 251
  - Audit procedures ......................................... 251

COMMUNICATIONS WITH CLIENT
- Communication with those charged with governance
  - Documentation of communications ....................... 343, 345
- Fraud and other illegal acts ................................ 345
- Internal control matters communication under SAS No. 115 ..................................................... 338

D

DRAFTING THE FINANCIAL STATEMENTS .................... 315
- Notes to the financial statements ......................... 316
- Required supplemental schedules ......................... 316

E

ENVIRONMENTAL REMEDIATION LIABILITIES ............ 255

EVALUATION OF AUDIT RESULTS
- Audit differences
  - Summary of audit differences ........................... 302
- Audit evidence ............................................... 289
- Evaluation of overall materiality ........................ 303

F

FORM 5500
- Other information in Form 5500, auditor responsibility for ........ 331
  - Material inconsistency ................................ 331
  - Material misstatement of fact ........................... 331
- Other information in electronic sites ....................... 331
- Preparation of Form 5500 by auditor ....................... 331
- Reading Form 5500 .......................................... 332
- Required supplemental schedules ......................... 316
  - Assets held for investment purposes .................. 316
  - Delinquent participant contributions .................. 316
  - Reportable transactions ................................ 316
  - Schedule G ............................................... 316

FRAUD
- Accounting estimates ........................................ 301
- Analytical procedures ...................................... 291
- Communication of fraud .................................... 291
- Material inconsistency .................................... 331
- Material misstatement of fact ........................... 331

GOING CONCERN CONSIDERATIONS
- Applicability of SAS No. 59 ................................ 267
- Applicability of SAS No. 59 to terminating plans ..... 267
- Audit procedures ............................................ 268
- Conditions and events ...................................... 267
- Documentation, requirements .............................. 269

I

ILLEGAL ACTS ............................................... 345

M

MANAGEMENT REPRESENTATION LETTER
- Audit adjustments ............................................ 283
- Content ....................................................... 281
- Materiality ................................................... 283
- Periods covered by the letter .............................. 284
- Signature and date on the letter ......................... 283

MATERIALITY
- Evaluation of overall materiality ........................ 303

O

OTHER INFORMATION IN FORM 5500, AUDITOR RESPONSIBILITY FOR
- Material inconsistency .................................... 331
- Material misstatement of fact ........................... 331

P

PARTY IN INTEREST
- Audit procedures ............................................ 266
- Definition ..................................................... 263
- Detection responsibility .................................... 266

PROHIBITED TRANSACTIONS
- Disclosures .................................................... 263, 267, 346

R

RELATED PARTIES ............................................. 263
- Audit procedures ............................................ 266
- Definition ..................................................... 263
- Detection responsibility .................................... 266
- Disclosures .................................................... 267
REPORTABLE TRANSACTIONS ........................................ 316

TAX CONSIDERATIONS AND REQUIREMENTS
- Auditor’s responsibility for plan tax status .................. 251
- Audit procedures for plan tax status ......................... 251
- Plan qualification
  - Auditor’s responsibility for plan tax status ............. 251
  - Audit procedures for plan tax status .................. 251

TERMINATING PLANS
- Applicability of SAS No. 59 to terminating plans .......... 267

WORKPAPERS
- Common peer review findings ................................ 297
- Review of workpapers ........................................ 296
- Engagement quality control review .......................... 296
- Review checklists ............................................. 297
- Tax department review ....................................... 296
- Timing of review .............................................. 296
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 1—Pre-engagement Activities and Audit Planning (EBPTG101)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle’s column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
EBPTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by February 28, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

<table>
<thead>
<tr>
<th>CPE Examination Questions (Lesson 1)</th>
<th>49</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPE Examination Questions (Lesson 2)</td>
<td>95</td>
</tr>
<tr>
<td>CPE Examination Questions (Lesson 3)</td>
<td>137</td>
</tr>
</tbody>
</table>
EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 1—Pre-engagement Activities and Audit Planning (EBPTG101)

Price $79

First Name: 
Last Name: 
Firm Name: 
Firm Address: 
City: __________________________ State /ZIP: __________________________
Firm Phone: __________________________ 
Firm Fax No.: __________________________ 
Firm Email: __________________________ 
Express Grading Requested: ☐ Add $24.95
Signature: __________________________
Credit Card Number: __________________________ Expiration Date: ____________
Birth Month: __________________________ Licensing State: __________________________

ANSWERS:
Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ○ not like this ⊗ ✗ ✓ .

a b c d a b c d a b c d a b c d a b c d
1. ○ ○ ○ ○ 11. ○ ○ ○ ○ 21. ○ ○ ○ ○ 31. ○ ○ ○ ○
2. ○ ○ ○ ○ 12. ○ ○ ○ ○ 22. ○ ○ ○ ○ 32. ○ ○ ○ ○
3. ○ ○ ○ ○ 13. ○ ○ ○ ○ 23. ○ ○ ○ ○ 33. ○ ○ ○ ○
4. ○ ○ ○ ○ 14. ○ ○ ○ ○ 24. ○ ○ ○ ○ 34. ○ ○ ○ ○
5. ○ ○ ○ ○ 15. ○ ○ ○ ○ 25. ○ ○ ○ ○ 35. ○ ○ ○ ○
6. ○ ○ ○ ○ 16. ○ ○ ○ ○ 26. ○ ○ ○ ○ 36. ○ ○ ○ ○
7. ○ ○ ○ ○ 17. ○ ○ ○ ○ 27. ○ ○ ○ ○ 37. ○ ○ ○ ○
8. ○ ○ ○ ○ 18. ○ ○ ○ ○ 28. ○ ○ ○ ○ 38. ○ ○ ○ ○
10. ○ ○ ○ ○ 20. ○ ○ ○ ○ 30. ○ ○ ○ ○ 40. ○ ○ ○ ○

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: February 28, 2011
Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC’s Guide to Audits of Employee Benefit Plans—Pre-engagement Activities and Audit Planning
Course Acronym: EBPTG101

Your Name (optional): ___________________________________________ Date: ______________________

Email: _______________________________________________________

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ● not like this ☒ ☒ ☐

<table>
<thead>
<tr>
<th>Satisfaction Level:</th>
<th>Low (1) . . . to . . . High (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rate the appropriateness of the materials for your experience level:</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>2. How would you rate the examination related to the course material?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>3. Does the examination consist of clear and unambiguous questions and statements?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>4. Were the stated learning objectives met?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>5. Were the course materials accurate and useful?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>7. Was the time allotted to the learning activity appropriate?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>8. If applicable, was the technological equipment appropriate?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>10. If applicable, how well did the audio/visuals contribute to the program?</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
</tbody>
</table>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

1. What did you find most helpful?  2. What did you find least helpful?

3. What other courses or subject areas would you like for us to offer?

4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________

5. How many employees are in your company? ________

6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here ________
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 2—Special Auditing Considerations (EBPTG102)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle’s column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
EBPTG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by February 28, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed EXAMINATION FOR CPE CREDIT ANSWER SHEET or by logging onto the Online Grading System. The EXAMINATION FOR CPE CREDIT ANSWER SHEET and SELF-STUDY COURSE EVALUATION FORM for each course are located at the end of all course materials.

Page

CPE Examination Questions (Lesson 1) ................................................................. 203
CPE Examination Questions (Lesson 2) ................................................................. 239
EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 2—Special Auditing Considerations (EBPTG102)

Price $79

First Name: 

Last Name: 

Firm Name: 

Firm Address: 

City: 

State/ZIP: 

Firm Phone: 

Firm Fax No.: 

Firm Email: 

Express Grading Requested: □ Add $24.95

Signature: 

Credit Card Number: 

Expiration Date: 

Birth Month: 

Licensing State: 

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ○ not like this ☒ ☐ ✔ ✔ .

1. ○ ○ ○ ○ 11. ○ ○ ○ ○ 21. ○ ○ ○ ○ 31. ○ ○ ○ ○
2. ○ ○ ○ ○ 12. ○ ○ ○ ○ 22. ○ ○ ○ ○ 32. ○ ○ ○ ○
3. ○ ○ ○ ○ 13. ○ ○ ○ ○ 23. ○ ○ ○ ○ 33. ○ ○ ○ ○
4. ○ ○ ○ ○ 14. ○ ○ ○ ○ 24. ○ ○ ○ ○ 34. ○ ○ ○ ○
5. ○ ○ ○ ○ 15. ○ ○ ○ ○ 25. ○ ○ ○ ○ 35. ○ ○ ○ ○
6. ○ ○ ○ ○ 16. ○ ○ ○ ○ 26. ○ ○ ○ ○ 36. ○ ○ ○ ○
7. ○ ○ ○ ○ 17. ○ ○ ○ ○ 27. ○ ○ ○ ○ 37. ○ ○ ○ ○
8. ○ ○ ○ ○ 18. ○ ○ ○ ○ 28. ○ ○ ○ ○ 38. ○ ○ ○ ○
10. ○ ○ ○ ○ 20. ○ ○ ○ ○ 30. ○ ○ ○ ○ 40. ○ ○ ○ ○

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: February 28, 2011
Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 2—Special Auditing Considerations

Course Acronym: EBPTG102

Your Name (optional): ___________________________ Date: ___________________________

Email: ___________________________

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ● not like this ☒ ☒ ☐.

<table>
<thead>
<tr>
<th>Satisfaction Level:</th>
<th>Low (1)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th>High (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rate the appropriateness of the materials for your experience level:</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. How would you rate the examination related to the course material?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Does the examination consist of clear and unambiguous questions and statements?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Were the stated learning objectives met?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Were the course materials accurate and useful?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Was the time allotted to the learning activity appropriate?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. If applicable, was the technological equipment appropriate?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. If applicable, how well did the audio/visuals contribute to the program?</td>
<td>○ ○ ○ ○ ○ ○ ○ ○ ○ ○</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

1. What did you find most helpful?  
2. What did you find least helpful?  

3. What other courses or subject areas would you like for us to offer?

4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting?  

5. How many employees are in your company?  

6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page.  Yes/No ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here ___
TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 3—
Concluding the Audit (EBPTG103)

1. Following these instructions is information regarding the location of the CPE CREDIT EXAMINATION QUESTIONS and an EXAMINATION FOR CPE CREDIT ANSWER SHEET. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at OnlineGrading.Thomson.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle’s column and with the question number.

Send your completed Examination for CPE Credit Answer Sheet, Course Evaluation, and payment to:

Thomson Reuters
Tax & Accounting—R&G
EBPTG103 Self-study CPE
36786 Treasury Center
Chicago, IL  60694-6700

You may fax your completed Examination for CPE Credit Answer Sheet and Course Evaluation to the Tax & Accounting business of Thomson Reuters at (817) 252-4021, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note:  The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, “Do not select this answer choice” will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by February 28, 2011. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an additional $24.95 per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the Examination for CPE Credit Answer Sheet should be submitted for grading. DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS. Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.
EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed EXAMINATION FOR CPE CREDIT ANSWER SHEET or by logging onto the Online Grading System. The EXAMINATION FOR CPE CREDIT ANSWER SHEET and SELF-STUDY COURSE EVALUATION FORM for each course are located at the end of all course materials.

Page

CPE Examination Questions (Lesson 1) ................................................................. 277
CPE Examination Questions (Lesson 2) ................................................................. 311
CPE Examination Questions (Lesson 3) ................................................................. 355
EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC’s Guide to Audits of Employee Benefit Plans—Course 3—Concluding the Audit (EBPTG103)

First Name: ____________________________
Last Name: ____________________________
Firm Name: ____________________________
Firm Address: __________________________
City: ____________________________ State /ZIP: __________________________
Firm Phone: __________________________
Firm Fax No.: __________________________
Firm Email: __________________________
Express Grading Requested: □ Add $24.95
Signature: ____________________________
Credit Card Number: ____________________________ Expiration Date: ____________________________
Birth Month: ____________________________ Licensing State: ____________________________

ANSWERS:
Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ◯ ○ ○ ○ .

1. ○ ○ ○ ○ 11. ○ ○ ○ ○ 21. ○ ○ ○ ○ 31. ○ ○ ○ ○
2. ○ ○ ○ ○ 12. ○ ○ ○ ○ 22. ○ ○ ○ ○ 32. ○ ○ ○ ○
3. ○ ○ ○ ○ 13. ○ ○ ○ ○ 23. ○ ○ ○ ○ 33. ○ ○ ○ ○
4. ○ ○ ○ ○ 14. ○ ○ ○ ○ 24. ○ ○ ○ ○ 34. ○ ○ ○ ○
5. ○ ○ ○ ○ 15. ○ ○ ○ ○ 25. ○ ○ ○ ○ 35. ○ ○ ○ ○
6. ○ ○ ○ ○ 16. ○ ○ ○ ○ 26. ○ ○ ○ ○ 36. ○ ○ ○ ○
7. ○ ○ ○ ○ 17. ○ ○ ○ ○ 27. ○ ○ ○ ○ 37. ○ ○ ○ ○
8. ○ ○ ○ ○ 18. ○ ○ ○ ○ 28. ○ ○ ○ ○ 38. ○ ○ ○ ○
10. ○ ○ ○ ○ 20. ○ ○ ○ ○ 30. ○ ○ ○ ○ 40. ○ ○ ○ ○

You may complete the exam online by logging onto our online grading system at OnlineGrading.Thomson.com, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: February 28, 2011
Self-study Course Evaluation

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☑ not like this ✗.

Your Name (optional): ________________________________ Date: ________________________________

Email: ____________________________________________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

Additional Comments:

1. What did you find most helpful? 2. What did you find least helpful?

3. What other courses or subject areas would you like for us to offer?

4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _________

5. How many employees are in your company? _________

6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☑ ☑

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in “no” and initial here _________