Audits of 401(k) Plans: New Developments and Critical Issues

AFPL/26/V1

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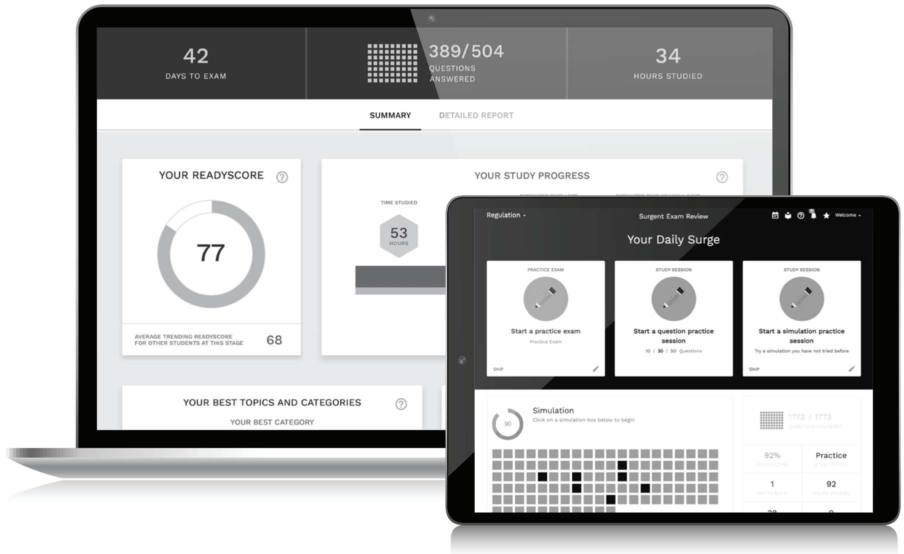

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Introduction to Employee Benefit Plans

Introduction to Employee Benefit Plans

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Discuss the differences between employee benefit plans;
- Describe the governmental rules and regulations surrounding employee benefit plans; and
- Understand the nuances of ERISA and ERISA Section 103(a)(3)(C) audits.

I. Background and basics of employee benefit plans

Auditors must understand the differences between the various types of employee benefit plans that may be encountered during the course of their career. The following information defines the types of employee benefit plans and the individual funding requirements that may be applicable for each type of plan that will assist auditors in planning and performing audits on employee benefit plans.

A. Pension plans

A pension plan provides retirement income to employees through employee and/or employer contributions. Pension plans may be easier to identify than welfare plans due to the fact that the amount the employee is entitled to receive may be easier to determine. A pension plan may allow employees to defer income on a pretax basis during the period covered by the plan and extend it to the termination of employment and beyond. Certain types of pension plans are exempt from the reporting and audit requirements, including severance pay plans, individual retirement accounts, supplemental payment plans, bonus programs, etc.

Regardless of whether the plan is a welfare or pension plan, the auditor should not be responsible for making the decision as to whether or not the plan is subject to the Employee Retirement Income Security Act of 1974 (ERISA) or the reporting and audit requirements – those decisions should be made by the plan sponsor as part of their many fiduciary responsibilities. The plan sponsors may seek guidance and assistance from their auditors in interpreting the complicated rules and audit requirements.

The DOL continues to scrutinize employee benefit plans due to:

a. Plan sponsors' lack of understanding fiduciary responsibilities;
b. Auditor's lack of sufficient experience and training in employee benefit plans;
c. Deficiencies noted in peer reviews; and
d. Deficiencies noted in Department of Labor (DOL) inspections.

Throughout this course, we will explore the fiduciary responsibilities of the plan sponsor and ways that the auditor can provide assistance. The deficiencies that have been noted in both peer reviews and the DOL inspection program will be discussed, including examples of procedures that may be performed to eliminate the deficiencies.

As noted above, there are two types of employee benefit plans: welfare and pension plans. However, welfare and pension benefit plans are further classified depending on how employee benefits are determined. The two most common types of welfare and pension plans are defined contribution and defined benefit plans. A defined contribution plan allows for employees to make contributions to individual accounts and the benefits that the participants are entitled to receive are limited to the vested amount in their individual participant account balance, whereas the benefits provided in a defined benefit plan are defined in the plan document and usually based on either the average earnings over a period of time or a schedule or formula based on years of service.

a. Defined contribution plans can be either welfare or pension plans.
b. Defined benefit plans can be either welfare or pension plans.

Even though the primary focus of this course is on defined contribution plans, both types of plans will be discussed below in more detail in order to provide auditors with basic information that will assist them with the planning and preparation of the audit.

B. Defined contribution plans

The primary focus of this course will be on defined contribution pension plans. A defined contribution plan may be defined as a pension plan in which a certain amount or percentage of money is set aside each year by the employee and/or the employer, subject to annual IRS limitations, for the benefit of the employee at the time of retirement. Separate accounts will be required for each participant in order to account for their contributions, earnings, losses, distributions, and participant loans, as applicable. The amount a participant is entitled to receive at the time of termination or retirement will be based in the individual account balance in accordance with the terms of the plan document.

There are some advantages to a defined contribution plan including, but not limited to, the following:

a. The employee can elect how much to contribute;
b. The plan can be funded through payroll deductions;
c. The plan can be easily understood by participants; and
d. Participants may have a variety of investment options.

Examples of defined contribution plans include 403(b) plans, profit-sharing plans, employee stock ownership plans (ESOPs), and 401(k) plans.

a. **403(b) plan** – Retirement plan similar to a 401(k) plan but offered by nonprofit organizations such as universities and charitable organizations rather than corporations.
b. **Profit-sharing plan** – Defined contribution plan that permits discretionary annual funding by the employer based on a share of the company's profits; generally allocated based on compensation.
c. **ESOP** – Defined contribution plan in which the company contributes its stock to the plan for the benefit of the employees.
d. **401(k) plan** – Retirement plan that allows employees to contribute on a pretax basis.

1. Traditional and safe harbor 401(k) plans

Since its inception in 1978, the 401(k) plan has grown into the most popular type of retirement plan. In order to plan for their retirement years, millions of workers depend on the money saved in these plans. A traditional 401(k) plan allows an employee to elect to receive their compensation in the form of cash or defer a specified dollar amount or percentage to a qualified benefit plan. Employees can contribute on a tax deferred basis until the money is withdrawn or distributed from the plan. The employee is not taxed on the elective deferrals or the earnings until a distribution is made from the plan due to retirement or termination of employment. Contributions can be made by the plan sponsor as well and allocated to the individual participant accounts in accordance with the allocation provisions in the plan document.

A safe harbor 401(k) plan is similar to a traditional 401(k) plan with the exception that, among other things, it must provide for employer contributions that are fully vested upon receipt in the plan. These contributions may be in the form of:

a. Employer matching contributions;
b. Limited to employees who defer; or
c. Employer contributions made on behalf of all eligible employees, regardless of whether they make elective deferrals.

The safe harbor 401(k) plan is *not* subject to the complex annual nondiscrimination tests that apply to traditional 401(k) plans. Furthermore, safe harbor 401(k) plans that do not provide any additional contributions in a year are exempted from the top-heavy rules of §416 of the Internal Revenue Code.

Historically, employers sponsoring safe harbor 401(k) plans had to satisfy certain notice requirements. In order to satisfy the notice requirements, a written notice of the employee's rights and obligations under the plan had to be provided to each eligible employee for the plan year. The notice also had to satisfy the content and timing requirements.

The content requirement required that the notice describe:

a. The safe harbor method in use;
b. How eligible employees make elections; and
c. Any other plans involved, and so on.

Employers were required to provide the written notice within a reasonable period of time *before* each plan year in which the safe harbor is elected. The timing requirement was deemed satisfied as long as the notice was provided to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year.

The original SECURE Act was enacted with provisions that became effective as of January 1, 2020. The SECURE Act legislation changes the nonelective contribution 401(k) safe harbor to provide greater flexibility, improve employee protection and facilitate plan adoption. The legislation eliminates the safe harbor notice requirement but maintains the requirement to allow employees to make or change an election at least once per year. The bill also permits amendments to nonelective status at any time before the 30th day before the close of the plan year. Amendments after that time would be allowed if the amendment provides (1) a nonelective contribution of at least four percent of compensation (rather than at least three percent) for all eligible employees for that plan year, and (2) the plan is amended no later than the last day for distributing excess contributions for the plan year, that is, by the close of following plan year.

Auditors should perform procedures to determine the plan's compliance with the rules and regulations of the DOL and the IRS, which include year-end compliance testing and other discrimination rules. Due to the nature of safe harbor plans, the annual nondiscrimination tests do not apply. Instead, the auditor will perform procedures to determine that the notice requirements have been met and that the employer contributions are classified 100 percent vested in the participant accounts.

Note:

> Both the traditional and safe harbor plans are for employers of any size and can be combined with other retirement plans.

Regardless of the type of plan, all defined contribution plans must be in writing in order to meet the requirements of the Employment Retirement Income Security Act (ERISA). ERISA protects the retirement assets of Americans by implementing rules that qualified plans must follow to ensure that plan fiduciaries do not misuse plan assets. There are certain ERISA requirements that a qualified plan must follow, including:

a. Providing participants with important information regarding plan options and features;
b. Establishing minimum requirements for eligibility, vesting, benefits, etc.;
c. Requiring accountability of plan fiduciaries; and
d. Protecting the plan from mismanagement and misuse of plan assets through its fiduciary provisions.

Unlike a 403(b) plan, 401(k) plans generally have eligibility requirements that must be met before an employee can participate in the plan. The eligibility requirements typically require a minimum age and/or completion of a specified length of service. Additional eligibility requirements may also be applicable for amounts contributed by the plan sponsor. It is strongly recommended that the plan sponsor obtain some form of acceptance or declination of participation in order to prove that the plan was offered to all eligible employees.

For example, the plan sponsor may provide an enrollment package to employees at the time of employment or once the minimum requirements for eligibility have been met. The following items are typically included in the enrollment package either in hardcopy or electronic format:

a. An enrollment form indicating participation or decline of participation; or instructions on how to enroll electronically;
b. If enrollment is electronic, then a best practice would be to have the employee initial the personnel file to indicate they received enrollment information;
c. An election form indicating the deferral percentage to be withheld from payroll;
d. A list of available investment options, including the appropriate prospectus for each investment option;
e. An allocation form indicating how the contributions should be allocated across the different investment options; and
f. A summary plan description.

Consider:

> Is the plan sponsor required to obtain an enrollment form indicating the employee's participation or declining the opportunity to participate? Are there alternative methods for documenting that the plan sponsor did not discriminate regarding participation?

As part of their fiduciary responsibilities, employers should offer a diverse group of investment options that are consistent with the plan's overall investment policy strategy. Every plan should have an investment policy statement that indicates the types of investments the plan is going to offer and how they will be monitored for continual performance.

Consider:

> What happens if the plan does not have an investment policy statement? If this is the case, the auditor should consider identifying this as a deficiency in internal control and reporting to those charged with governance. It is the responsibility of those charged with governance and management to provide a suitable mix of investment options and to monitor those investments to ensure that they continue to be viable investment options.

There are two types of directed investment options. If the employees are allowed to select their individual investments based on their own personal preferences and goals, then the investments are considered participant directed. When all or a portion of the employee's deferral is required to be invested in the employer's stock or other specified investment, then it is considered a non-participant directed investment option. There are different reporting and disclosure requirements for participant directed and non-participant directed investments that will be addressed in a later chapter.

II. Governmental regulations and reporting requirements for 401(k) plans

Employee benefit plans are required to provide annual information to various federal government agencies, including the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL). The reporting requirements for 401(k) plans as well as other types of benefit plans are defined by ERISA. Benefit plans are required to file the Form 5500 annually with the DOL. If required, then a copy of the plan's audited financial statements will accompany the Form 5500 filing. The financial information for an audited plan is presented on the statement of net assets available for benefits (balance sheet) and the statement of changes in net assets available for benefits (income statement). The amounts presented on the statement of net assets available must be comparative, but the statement of changes can be presented in a single year format. Financial statements for the plan can be prepared in accordance with generally accepted accounting principles (GAAP) or on a cash basis, depending on the need of the users of the financial statements. If the financial statements are prepared on a basis of accounting other than GAAP, then this fact must be disclosed in the footnotes to the financial statements.

The Form 5500 is required to be filed with the DOL by the end of the seventh month following the plan's year end. A calendar year end plan would be required to file the Form 5500 with the accompanying audited financial statements by July 31 of the following year. There are two ways that a plan can receive an extension of time:

a. An automatic extension of time will be granted in certain situations. For example, if the plan sponsor for a calendar year-end plan has an original corporate tax return due date of March 15th but files the appropriate extension for the corporate return and the new due date is September 15th, the plan's Form 5500 filing will automatically be extended through September 15th.
b. Complete and file Form 5558 by the original due date of the plan's Form 5500.

In addition to financial statements that must accompany the Form 5500 when applicable, ERISA also requires certain information to be communicated to the participants on an annual basis. Participants must be provided with a statement of their vested and non-vested accrued benefits as well as a Summary Annual Report (SAR).

Depending on the nature of the investment options offered in a 401(k) plan, then the plan may be subject to more reporting and auditing rules in addition to the rules and regulations of ERISA and the IRS. If a defined contribution 401(k) plan offers registered employer securities as an investment option and the employer stock is required to file Form S-8 with the Securities and Exchange Commission (SEC), then the plan is also required to register and file a report with the SEC under the Securities Exchange Act of 1934. Plans that offer registered employer stock as an investment option are required to file Form 11-K with the Public Company Accounting Oversight Board (PCAOB). The 1933 Securities Exchange Act exempts plans from registration if employee contributions are not utilized to purchase employer stock. The reporting requirements for 11-K plans are slightly different than the reporting requirements for non-11-K filers. The financial statements for 11-K plans must be prepared in accordance with standards issued by the PCAOB instead of GAAS, which results in two audit opinions that must be prepared. Please note that the DOL will not accept financial statements prepared in accordance with the PCAOB and the SEC will not accept financial statements prepared in accordance with GAAP.

Furthermore, 11-K plans can elect to file the financial statements in accordance with either the requirements of the SEC Act of 1934 or in accordance with ERISA. The SEC Act of 1934 requires the financial statements to be filed with the PCAOB within 90 days following the plan's year end whereas ERISA requires the financial statements to be filed within 180 days of the plan's year end. The number of days is literal and does not take into account holidays or weekends. For example, June 30th may not by the 180th day depending on whether or not it is a leap year. Other differences for an 11-K plan include the fact that the SEC will not accept a limited-scope audit report so the investments and investment related income must be subjected to full scope audit procedures. This course will focus on plans that are not required to register with the SEC or comply with other reporting requirements associated with 11-K filings.

Financial statements are assumed to be prepared on an accrual basis of accounting in accordance with generally accepted accounting principles. However, ERISA allows financial statements to be prepared on the cash basis or other comprehensive basis of accounting. If the audited financial statements are prepared in accordance with GAAP on the accrual basis of accounting and the Form 5500 is prepared on the cash basis, then a reconciling footnote must be included in the notes to the financial statements. The total amount of net assets available for benefits and total change in net assets available for benefits must be reconciled to the exact dollar. There may be other classification differences between the financial statements and the Form 5500, but the total net assets and total changes in net assets must agree.

Discussion question:

When are audited financial statements required to accompany the Form 5500 filing?

The Form 5500 requires financial information to be reported on an annual basis. The financial information is presented on the appropriate schedule based on whether the plan is required to file as a small or large plan. Large plans are required to include financial statements audited by an independent qualified public accountant with the Form 5500 annually. Through plan years ending December 31, 2022, the audit requirement was based on the number of **eligible** participants as of the beginning of the plan year.

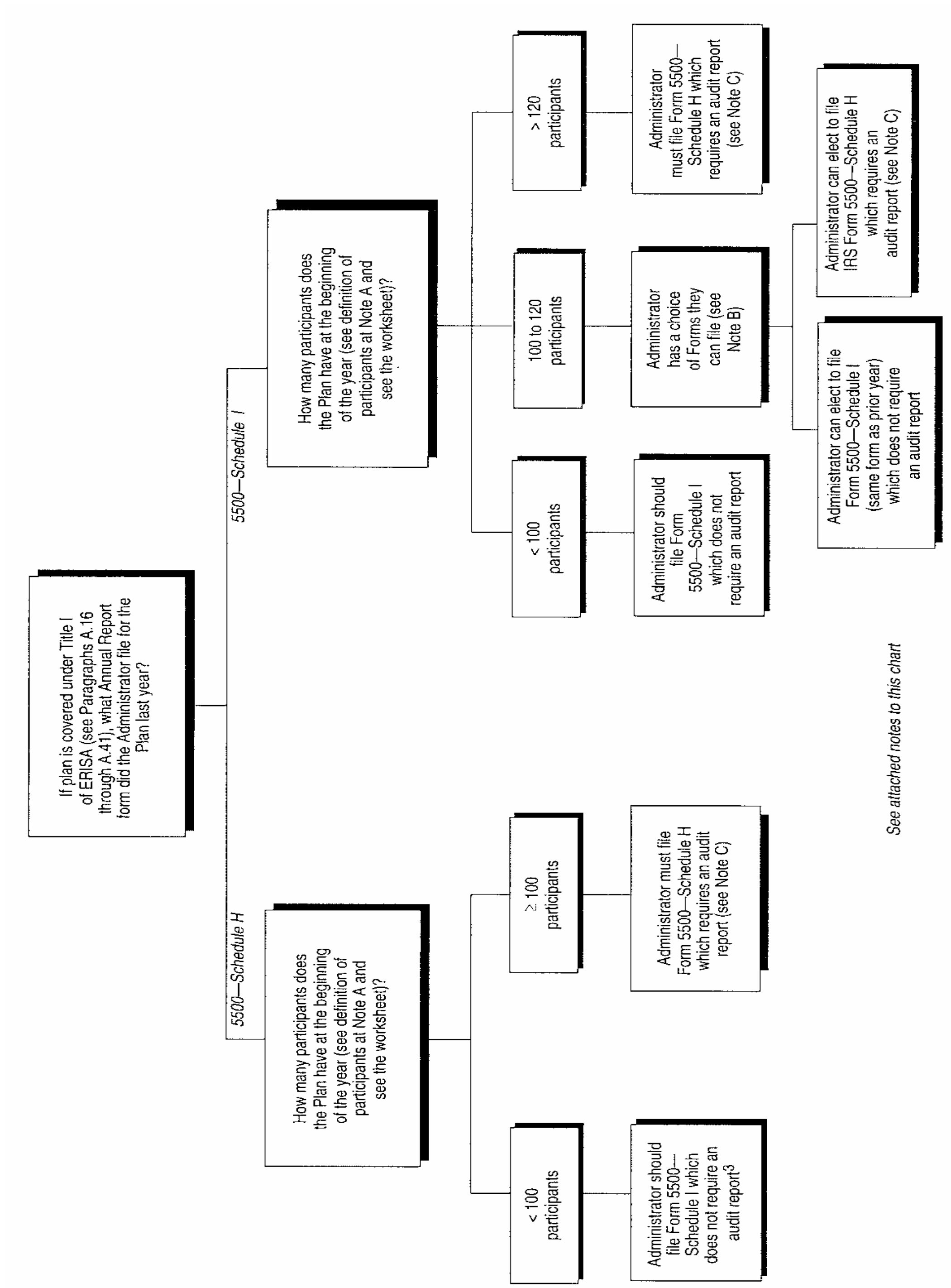
On February 23, 2023, the DOL (along with IRS and PBGC) issued a pair of Federal Register Notices which announced changes to Form 5500 which will be effective for plan years beginning on or after January 1, 2023. Key among these revisions was an expected change in the threshold for determining which plans will require an independent audit of its financial statements to be attached to the Form 5500 filing.

A defined contribution plan would now be able to only consider those participants with an account balance in determining whether the plan was a large or small plan. "Small plans" are still eligible for the conditional waiver of the annual audit requirement.

While the 100-participant threshold is still in place, it would now only apply to those with account balances, at the beginning of the plan year. For example, if your plan had 150 eligible participants but only 75 of them had account balances at January 1, 2023, your plan would not be subject to the audit requirement for the 2023 plan year.

Once a plan has reached 100 participants with account balances as of the beginning of the year, then the plan is considered to be a **large plan** and is subject to the audit requirement. However, there is an exemption from the audit requirement for plans that have between 80–120 participants with account balances at the beginning of the year. In accordance with the 80–120 rule, plans that have between 80 and 120 participants with account balances at the beginning of the plan year can elect to file as either a small or large plan depending on the annual return that was filed in the previous year. As noted above, plans that have 100 or more participants with account balances at the beginning of the year are required to have an annual audit of their financial statements, but if the plan has between 80–120 participants with account balances, then the audit requirements can be waived until the plan has more than 120 participants with account balances. If the plan has fewer than 100 participants, but at least 80, then the plan can elect to file as a large plan and audited financial statements must be completed.

Exhibit 1: The Audit Decision Tree



Note A: Participants as defined by the DOL

Active participants
Active participants (such as any individuals who are currently in employment covered by the plan and who are earning or retaining credited service under the plan) – This includes any individuals who are eligible to elect to have the employer make payments under a Code Section 401(k) qualified cash or deferred arrangement. Active participants also include any nonvested individuals who are earning or retaining credited service under the plan. This does not include *(a)* nonvested former employees who have incurred the break in service period specified in the plan or *(b)* former employees who have received a “cash-out” distribution or deemed distribution of their entire nonforfeitable accrued benefit.

Retired or separated participants receiving benefits
Retired or separated participants receiving benefits (such as individuals who are retired or separated from employment covered by the plan and who are receiving benefits under the plan). This does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan.

Other retired or separated participants entitled to future benefits
Other retired or separated participants entitled to future benefits (such as any individuals who are retired or separated from employment covered by the plan and who are entitled to begin receiving benefits under the plan in the future) – This does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan.

Deceased participants
Deceased participants who had one or more beneficiaries who are receiving or are entitled to receive benefits under the plan. This does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the beneficiaries of that individual are entitled under the plan.

Note B: 80-120 Rule

Under DOL Reg. 2520-103-1(d), if a plan has between 80 and 120 participants (inclusive) as of the beginning of a plan year, it may elect to file the same category of form it filed the year before and avoid the audit requirement. This means that plans with between 80 and 120 at the beginning of the plan year that filed a Form 5500, Schedule I, “Financial Information – Small Plan,” in the prior year may elect in the current year to complete the Form 5500 following the requirements for a “small plan.” There is no limit to the number of years that this election can be made. DOL officials have indicated that health and welfare plans with 100 or more participants which involve employee contributions generally must have an audit unless employee contributions are used to purchase insurance from a third-party insurer or forwarded to an HMO within prescribed timeframes, even if the sponsor does not maintain a trust and considers the assets to be subject to the rights of the general creditors. Careful consideration should be given in these circumstances as to whether an audit is required. This rule is effective through plan years ending December 31, 2022.

Note C: Audit Requirement

If a Form 5500 is filed, an audit of the financial statements is generally required except that: (1) plans that have a short plan year of seven months or less may elect to defer (but not eliminate) the audit requirement; and (2) plans whose sole assets are insurance contracts that fully guaranteed benefit payments are not required to be audited.

Small pension plans are generally not subject to the audit requirement. However, there are certain restrictions that must be met in order to remain exempt from the audit requirement.

The Form 5500 filing deadline is seven months following the plan's year-end and the audited financial statements must be attached. In the case of a new defined contribution 401(k) plan, the audit requirement may be postponed if the initial plan year is seven months or less. Audited financial statements for the short plan year as well as the next full calendar period must accompany the subsequent Form 5500.

The Form 5500 is required to be filed with the DOL until all of the assets in the plan have been distributed from the plan. The final return for a Form 5500 will be due seven months from the date the total assets of the plan were distributed. For example, if a decision is made to terminate the plan as of June 30, 20X5, then the plan's audited financial statements must be prepared on the liquidation basis of accounting and the termination disclosed in the footnotes because the decision was made before the end of the year. The plan is still subject to the audit and reporting requirements through the end of 20X5 as long as there are more than 100 participants with account balances as of the beginning of the 20X5 plan year and there are remaining assets in the plan. So, if the plan had more than 100 participants with account balances as of January 1, 20X5, then the plan is required to file as a large plan and is subject to the audit even if a decision has been made to terminate the plan. Therefore, to continue the example, if the assets are subsequently transferred to a new plan as of April 30, 20X6, then the plan would be subject to an audit for the year ended December 31, 20X5, and the period ended April 30, 20X6 (as long as there were more than 100 participants with account balances as of January 1, 20X5 and January 1, 20X6) and file a Form 5500 for both periods. The final Form 5500 would be due seven months from April 30, 20X6, or November 30, 20X6.

III. Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

In July 2019, the AICPA's Auditing Standards Board (ASB) issued Statement on Auditing Standards No. 136 (SAS 136), *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (AICPA, *Professional Standards* AU-C 703). This SAS addresses the auditor's responsibility to form an opinion on the financial statements of employee benefit plans (EBPs) subject to the Employee Retirement Income Security Act of 1974 (ERISA), hereinafter referred to as ERISA plans. It also addresses the form and content of the auditor's report issued as a result of an audit of ERISA plan financial statements. This SAS applies to audits of single employer, multiple employer, and multiemployer plans subject to ERISA. This SAS should not be adapted for plans that are not subject to ERISA. This SAS also addresses the auditor's responsibilities for forming an opinion on ERISA plan financial statements, including the form and content of the report when management elects to have an audit performed pursuant to ERISA Section 103(a)(3)(C) (hereinafter referred to as an ERISA Section 103(a)(3)(C) audit).

When management elects an ERISA Section 103(a)(3)(C) audit, the audit need not extend to any statements or information related to assets held for investment of the plan (hereinafter referred to as investment information) by a bank or similar institution or an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency, provided that the statements or information regarding assets so held are prepared and certified to by the bank or similar institution or insurance carrier in accordance with the Code of Federal Regulations (CFR), *Labor*, Title 29, Section 2520.103-5 of the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA.

When management elects to have an ERISA Section 103(a)(3)(C) audit, it must be determined whether:

a. An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances;
b. The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8;
c. The certification meets the requirements in 29 CFR 2520.103-5; and
d. The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework.

When management elects to have an ERISA Section 103(a)(3)(C) audit, the auditor should inquire of management about how management determined that the entity preparing and certifying the investment information is a qualified institution. The auditor should evaluate management's assessment of whether the entity issuing the certification is a qualified institution under DOL rules and regulations. If the auditor has concerns about whether the entity preparing and certifying the investment information is a qualified institution, the auditor should discuss his or her concerns with management. If management does not provide sufficient information that supports its determination that the entity preparing and certifying the investment information is a qualified institution, then the auditor should discuss their concerns with those charged with governance and determine the implications for the audit

The auditor should obtain the agreement of management or those charged with governance that it acknowledges and understands its responsibility to provide to the auditor, prior to the dating of the auditor's report, a draft of Form 5500 that is substantially complete. A substantially complete draft of Form 5500 includes the forms and schedules that could have a material effect (qualitative or quantitative) on information in the financial statements and ERISA-required supplemental schedules.

SAS 136 was effective for periods ending on or after December 15, 2021.

The certification must be obtained from a qualifying financial institution such as a bank, trust company, or insurance company that is regulated and supervised by a state or federal agency. Investment broker/dealers and third-party record keepers are not eligible to provide certifications. That is not to say that they cannot provide certifications, but the certification will not be valid.

Another key auditing consideration is related to the signature on the certification. The auditor should apply procedures to determine whether or not the individual that signed the certification is eligible to sign on behalf of the trustee or custodian and that they were still an employee of the trustee or custodian. Furthermore, in the case of an agency relationship and the agent provides the certification, the auditor should obtain a copy of the agency agreement to ensure it is a valid contract. Once the relationship has been substantiated, then the auditor should refer to the agent in the audit report. The plan administrator will instruct the auditor that they are not to perform audit procedures on information certified as complete and accurate by the trustee or custodian. The certification must contain the words "complete and accurate" in order to be valid. If the certification does not contain these exact words, then an audit in accordance with ERISA 103(a)(3)(C) cannot be performed. Some organizations will attempt to modify the certification by using a different variation in the wording or adding a disclaimer stating that the information is complete and accurate to the best of their knowledge. The auditor must be very careful when examining the certification to ensure that it is valid and use their judgment to determine whether or not they will rely on the certification to perform a limited-scope audit.

Plan administrators should consider using the ERISA 103(a)(3)(C) certification assessment tool from the Employee Benefit Plan Audit Quality Center to document their evaluation of the certification. If the plan administrator determines that the conditions for an ERISA 103(a)(3)(C) audit have not been met, then the plan is not able to have an audit performed in accordance with ERISA 103(a)(3)(C).

Note:

> Audit procedures are required regardless of whether or not an ERISA 103(a)(3)(C) is elected by plan management when it comes to the investment income allocated to individual participant accounts. Auditors must understand that the investment income allocated to individual participant accounts must be tested for ERISA and ERISA 103(a)(3)(C) audit engagements.

There are times when a certification may only be available for a portion of the investments. For example, a certification may be provided by the trustee that covers all of the mutual funds offered in the plan but does not certify the self-directed brokerage account. The auditor must perform audit procedures on the self-directed brokerage account and can apply the certification to all other investments. The auditor should still be able to issue the ERISA 103(a)(3)(C) audit opinion but must identify in the footnotes to the financial statements the specific investments that are covered under the certification and those that are not certified.

Plans required to file Form 11-K in accordance with SEC rules and regulations are not eligible for an ERISA 103(a)(3)(C) audit.

Below are several examples of acceptable certifications for the limited-scope audit requirement.

Example 1: ***Certification from a qualifying institution***
XYZ bank hereby certifies that the attached statements furnished pursuant to 29 CFR 2520.103-5I are complete and accurate.

Example 2: ***Certification from a qualifying institution***
XYZ bank hereby certifies that the attached statements furnished pursuant to 29 CFR 2520.103-5I are complete and accurate, to the best of our knowledge.

Example 3: ***Certification from a qualified trust company***
The information provided in the attached report is a summary of the financial activity for the trust, trusteed by ABC Trust Company (ABC) for the 403(b) Plan for the plan year ending 12/31/20X1, and includes all applicable contributions received by the trust through this date. This summary is subject to the terms and conditions of the Plan Document and Trust Agreement. ABC, as trustee, hereby certifies the existence of the plan assets which are under our control and reflected in the enclosed report. ABC further certifies that the information in the enclosed reports is complete and accurate. This statement is being furnished pursuant to 29 CFR 2520.103-5(d).

By: ______________________________Title: President, Authorized Signatory
Date:

Note 1: The above certification may enable the Plan to qualify for the "limited-scope" audit under CFR 2520.103-8 of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, if ABC is the trustee. ABC is a chartered trust company regulated, supervised, and subject to periodic examinations by a state agency. The certification only applies to the period during the plan year that Plan assets were recorded and kept by ABC Trust Company and were under the control of ABC as trustee. Please consult with the Plan's independent public accountants for further information.

Note 2: Please contact the plan's recordkeeping representative if additional plan documentation is required.

IV. Bonding requirements

ERISA bonding requirements are intended to protect employee benefit plans from risk of loss due to fraud or dishonesty on the part of persons that handle plan funds or other property. Every fiduciary of an employee benefit plan is required to be bonded in accordance with ERISA Section 412. Plan sponsors often confuse the bonding requirement with their coverage under other insurance policies. However, the fidelity bond is a separate agreement from the fiduciary coverage that is provided under the general umbrella policy of a corporate policy. The fidelity bond may be applicable to cover several fiduciaries at one time and is renewable annually. The minimum amount of the bond must be equal to at least 10 percent of the amount of the funds managed or handled by the fiduciary. The minimum amount of fidelity bond is $1,000 up to a maximum required bond amount of $500,000. The bond amount is required to be fixed as of the beginning of the calendar, policy, or fiscal year that represents the plan's reporting year.

In the event that a plan fails to obtain a fidelity bond or the bond lapses, the auditor should disclose the fact in the notes to the financial statements and whether or not the plan administrator has since renewed or obtained a bond.

Engagement Planning

Engagement Planning

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Understand the planning process for an employee benefit plan audit; and
- Identify procedures that should be performed for an efficient and effective audit.

I. Timing and scheduling of planning and fieldwork

One advantage to auditing employee benefit plans is that the audit fieldwork usually does not occur until after April 15th for calendar year-end plans. The Plan Sponsor is required to submit census information to the trustee or custodian or other benefits consultant within a specified time frame to determine whether or not the plan is in compliance with tax rules and regulations. Upon completion of the census testing, the annual reports will be prepared by the service provider and delivered to the plan sponsor. Historically, the year-end accounting records and audit package was not available until sometime in May or June. Due to changes in technology, the service provider may be able to prepare the audit package in electronic format or provide access to the information via secure website, which may result in the auditors gaining access much earlier than June. The timing of when the audit package is available is usually the deciding factor of when fieldwork will begin.

In addition to the preconditions for an audit in AU-C Section 210, *Terms of Engagement*, the auditor should obtain the agreement of management that it acknowledges and understands its responsibility for the following:

a. Maintaining a current plan instrument, including all plan amendments;
b. Administering the plan and determining that the plan's transactions that are presented and disclosed in the ERISA plan financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants to determine the benefits due or which may become due to such participants; and
c. When management elects to have an ERISA Section 103(a)(3)(C) audit, determining whether:
    (i) An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances;
    (ii) The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8;
    (iii) The certification meets the requirements in 29 CFR 2520.103-5; and
    (iv) The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework.

A. Engagement letter

It is common practice to send the prep list along with the engagement letter for the current year audit. An engagement letter is required for all audit engagements and will identify the period for which an audit is to be performed. Even though engagement letters are required in accordance with auditing standards, they are also a very important tool because they represent a contract between the auditor and the plan sponsor (or benefits committee). Therefore, it is critical that the engagement letter be tailored specifically for each plan. There are many different examples and templates that are available to auditors that will assist in the preparation of an engagement letter. However, this widespread availability of templates has enabled auditors to prepare the engagement letter in a "routine" manner without considering information that may be significant to a particular engagement. Many of the templates include “additional considerations” at the end of the template or throughout the body of the template. These additional considerations should be carefully reviewed and considered by the auditor to determine if they relate to the plan. Since there are differences between every plan, the auditor should take the necessary precautions to make the engagement letter specific for each client and not rely solely on a canned template.

There are many items that must be included in the engagement letter and only a few of them are listed below:

a. Basis of accounting on the financial statements.
b. Auditor’s responsibilities for fraud.
c. Management’s responsibilities for internal control.
d. Level of responsibility assumed by the auditor for the supplemental schedules that accompany the financial statements.
e. Consideration of the plan’s qualification for tax-exempt status.
f. Responsibility to review the information in the Form 5500.
g. Fees charged for the engagement.
h. When management elects to have an ERISA Section 103(a)(3)(C) audit, management or those charged with governance is responsible for determining whether:
    (i) An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances;
    (ii) The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8;
    (iii) The certification meets the requirements in 29 CFR 2520.103-5; and
    (iv) The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework.

An area that sometimes gets overlooked in the engagement letter relates to bookkeeping and other nonattest services. If the auditor performs nonattest services, such as actuarial services, preparation of the Form 5500, or bookkeeping services such as **preparing the financial statements**, the auditor should comply with Ethics Interpretation 1.295, “Performance of Nonattest Services.” The Interpretation requires practitioners providing nonattest services to their attest clients to establish and document, in writing, an understanding with the client about the nonattest services. Part of that understanding is the client’s acceptance of its responsibilities for the nonattest services.

The engagement letter should be modified as necessary to list all of the nonattest services provided. For example, if the auditor will perform bookkeeping services in addition to actuarial services, the following language could be added:

> “You are also responsible for management decisions and functions; for designating an individual with suitable skill, knowledge, or experience to oversee the bookkeeping, actuarial, and any other nonattest services we provide. If the auditor is not providing nonattest services, the Interpretation does not apply, and the engagement letter would not need to be modified.”

Some auditors may prefer to have the client specifically designate in the engagement letter the individual(s) responsible for overseeing the nonattest services. In that case, the engagement letter should state:

> "You are also responsible for making all management decisions and performing all management functions; for designating an individual, [*Name of Designated Individual*], with suitable skill, knowledge, or experience to oversee any bookkeeping, actuarial, or any other nonattest services we provide; and for evaluating the adequacy and results of those services and accepting responsibility for them."

Upon completion of the engagement letter, the auditor should review and discuss the letter with the plan sponsor. Many times, the plan sponsor receives the engagement letter and simply turns to see what the fee is for the current year but does not read the entire letter. By discussing the letter with the client every year, this will help prevent misunderstandings regarding the engagement and the responsibilities of both parties.

After the engagement letter has been reviewed by the client and agreed to, then the auditor is ready to begin the planning stage of the audit.

II. Understanding the plan and its environment

A. Documenting the understanding

Prior to starting the testing stage of the audit, the auditor should consider scheduling one to two days for the planning process instead of combining the planning and testing into the same week. This will allow the auditor time to:

a. Properly review plan documents and amendments made during the current and prior year;
b. Obtain an understanding of the plan and its environment;
c. Select samples for various audit areas;
d. Document their understanding of internal controls; and
e. Perform the walk-throughs as required by the risk assessment standards.

In order to obtain an understanding of the plan and its environment, an auditor must read the plan document, amendments to the plan, and service provider agreements. In addition to reading these items, an auditor should inquire of the plan sponsor, the plan administrator, management, and other key personnel regarding the operations and administration of the plan. The inquiries will assist the auditor in documenting the nature of the plan, the attitudes and awareness of plan management, and changes in plan operations.

Key elements in regard to obtaining an understanding of the plan include consideration of the following:

a. Industry, regulatory, and external factors;
b. The nature of the entity;
c. The entity's objectives, strategies, and related business risks; and
d. The entity's financial performance.

SAS 136 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control in accordance with AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

AU-C Section 300, *Planning an Audit*, requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan. The plan instrument is essential to understanding the plan and identifying and performing audit procedures that are responsive to assessed risks.

The auditor should obtain and read the most current plan instrument for the audit period, including effective amendments, as part of obtaining an understanding of the entity sufficient to perform risk assessment procedures.

When designing and performing audit procedures, the auditor should consider relevant plan provisions that affect the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures.

Obtaining an understanding of the plan and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The auditor's understanding of the plan establishes a frame of reference for planning the audit and exercising professional judgment throughout the audit when the auditor does the following:

a. Assesses the risks of material misstatement of the financial statements, including the related disclosures;
b. Determines materiality in accordance with AU-C Section 320, *Materiality in Planning and Performing an Audit*;
c. Considers the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
d. Identifies areas for which special audit consideration may be necessary;
e. Develops expectations for use when performing analytical procedures;
f. Responds to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
g. Evaluates the sufficiency and appropriateness of audit evidence obtained.

ERISA Section 402 requires that EBPs be established and maintained pursuant to a written plan instrument. The IRC requires that the provisions in the plan document satisfy the requirements of the IRC; therefore, the plan provisions are required to be followed. The plan instrument for defined benefit pension plans and defined contribution pension plans is generally referred to as a *plan document*. Multiple documents for such plans, as well as health and welfare plans, may comprise the plan instrument. Among other requirements, for a plan to be qualified, the plan instrument must be in writing and communicated to employees. The terms of the plan instrument generally deal with matters such as eligibility of participants, entitlement to benefits, funding, plan amendments, operation and administration of plan provisions, identification of the plan's fiduciary, allocation of responsibilities among those who serve in a capacity as a fiduciary, and delegation of fiduciary duties in connection with the administration of the plan.

The auditor should consider relevant plan provisions that affect the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures when designing and performing audit procedures. The relevant plan provisions will vary for each type of plan and the circumstances of each engagement. When designing audit procedures, the testing of relevant plan provisions may be coordinated among the various audit areas to which they relate.

The following are some examples of plan provisions often included in a plan instrument by audit area (this list is not all-inclusive).

a. Individual participant accounts:
   (i) Participation and eligibility requirements;
   (ii) Types of contributions and distributions;
   (iii) Timing of contributions;
   (iv) Contribution limitations;
   (v) Investment of contributions;
   (vi) Allocations to participant accounts;
   (vii) Forms of distributions;
   (viii) Benefit commencement dates;
   (ix) Vesting and forfeitures;
   (x) Service requirements and credits;
   (xi) Participant loans;
   (xii) Transfers; and
   (xiii) Administration of the plan.
b. Contributions and contributions receivable:
   (i) Participation and eligibility requirements;
   (ii) Types of contributions;
   (iii) Timing of contributions;
   (iv) Contribution limitations;
   (v) Investment of contributions;
   (vi) Use of forfeitures;
   (vii) Service requirements and credits; and
   (viii) Allocations to participant accounts.
c. Distributions and related obligations:
   (i) Eligibility requirements (distributable events);
   (ii) Types of distributions;
   (iii) Forms of distribution;
   (iv) Benefit commencement dates;
   (v) Determination of benefits;
   (vi) Vesting;
   (vii) Service requirements and credits; and
   (viii) Allocations to participant accounts.
d. Claims (in a health and welfare plan):
   (i) Eligibility requirements;
   (ii) Types of claims;
   (iii) Claims coverage; and
   (iv) Determination of claims.
e. Loans to participants:
   (i) Eligibility requirements;
   (ii) Loan terms; and
   (iii) Allocations to participant accounts.

f. Investments and investment income:
   (i) Investment of contributions;
   (ii) Administrative provisions;
   (iii) Direction of investments; and
   (iv) Allocations to participant accounts.
g. Expenses:
   (i) Administrative provisions; and
   (ii) Allocations to participant accounts.

Auditors can document their understanding of the plan in many different manners. One of the most common ways to document their understanding is by utilizing a checklist. A checklist allows the auditor to capture the inquiries made and responses received from the plan sponsor, administrator, and others regarding the nature of the plan and its environment. The checklist; however, is a tool and the auditor must use their judgment to determine when and if they have obtained a sufficient understanding of the plan and whether it is documented properly.

B. Analytical review procedures used during risk assessment

Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, addresses the use of analytical procedures as risk assessment procedures (which may be referred to as analytical procedures used to plan the audit).

Analytical procedures help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Analytical procedures performed as risk assessment procedures may, therefore, assist in identifying and assessing the risks of material misstatement by identifying aspects of the entity of which the auditor was unaware or understanding how inherent risk factors, such as change, affect susceptibility of assertions to misstatement.

Auditors typically compare prior year financial statement balances to current year balances as of year-end or at an interim date. This is a common and acceptable method of performing analytical review procedures; however, the auditor should also consider documenting inquiries and observations from various levels of management and other employees in a different manner. Analytical procedures can also be documented in the form of a memo that captures the pertinent expectations. If the plan has changed service providers or the investment mix; or made amendments to the plan document, then the auditor should also include these items in the analytical procedure documentation.

Analytical procedures, when used in the planning of an audit, should consider non-financial information in addition to the financial data such as the number of eligible participants and terminated participants.

Discussion question:

What type of analytical procedures does your firm currently perform?

Exhibit 1 is an example of an alternative analytical procedure that can be utilized in place of comparing prior year to current year financial information, which may assist the auditor in performing a more efficient and effective audit.

Exhibit 1:

Company Name:
Year End:
Analytical Procedures used in Risk Assessment

Due to the nature of employee benefit plan audits, planning and fieldwork do not typically commence until several months subsequent to the Plan's year-end. When the analytical procedure is performed during risk assessment, actual year-end information is available from the Plan Trustee/Custodian. Therefore, we have determined that it is not considered necessary to define expectations for each item on the financial statements. In order to satisfy the analytical procedure requirements, broad expectations for benefit plan clients are included below. Furthermore, we will conduct interviews with the appropriate level of management to identify and document current year relationships, fluctuations and all other significant items that occurred during the year.

Therefore, the following relationships associated with employee benefit plan audits can be expected:

1. Investment activity is expected to fluctuate according to overall market performance.
2. Contributions are expected to fluctuate depending on the number of participants, changes in employee deferrals, changes in employer matching contributions, etc.
3. Benefit payments are expected to fluctuate based on the number of participants terminated during the year or reaching retirement age.

We contacted NAME, TITLE, on DATE to discuss Company operations and changes during the year. Per our discussion:

Changes in the number of employees/participants:____________________
Changes in Service Providers: ____________________________________
Other changes during the year: ___________________________________
There were no changes or amendments in the plan provisions during the year.

The following changes or amendments were made to the plan during the year ended December 31, 2022:

Investments: There were no significant changes in the investment mix during the year.

		2025		2024
Total participants per form 5500				
Total assets per Trust Report				
Ee contributions per Trust Report				
Ratio of Ee contributions per Trust Report				
Ratio of Assets per plan participants				

No unusual fluctuations noted.

Conclusion

Based on review of data and discussions with management:

No modifications to audit procedures deemed necessary.

C. Communication with those charged with governance

AU-380, *The Auditor's Communication With Those Charged With Governance*, originally issued as SAS 114 and now clarified as AU-C 260, requires the auditor to identify the person or group responsible for overseeing the strategic direction of the entity, which includes the financial reporting process. The auditor's responsibilities should be clearly communicated with those charged with governance. Inquiries should be made of those charged with governance to obtain information relevant to the audit. Timely observations from the audit should also be communicated to those charged with governance that are relevant to overseeing the financial reporting process. In order to identify those charged with governance, the auditor should read plan documents and amendments, make inquiries of plan management, read the minutes to board meetings or the benefits committee meetings.

In accordance with AU-C Section 260, the auditor should communicate with those charged with governance and overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (SAS 136 Ref: par. A19– A24). Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process. AU-C Section 260 does not preclude the auditor from communicating additional matters. Other matters regarding the planned scope and timing of the audit may include the following:

a. How the auditor plans to address significant risk of material misstatement whether due to fraud or error.
b. How the auditor proposes to address areas of higher assessed risk of material misstatement.
c. The nature and extent of specialized skills or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.
d. The auditor's planned approach to addressing the implications for the individual statements and the disclosures of any significant changes within the applicable financial reporting framework or in the entity's environment, financial condition, or activities.
e. When engaged to report on key audit matters, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and that therefore may be key audit matters.
f. The auditor's approach to internal control relevant to the audit.
g. The application of materiality in the context of an audit, as discussed in AU-C Section 320, *Materiality in Planning and Performing an Audit*.
h. If the plan has an internal audit function, the extent to which the auditor will use the work of internal audit and how the external and internal auditors can best work together.
i. The views of those charged with governance about the following matters:
    (i) The appropriate person(s) in the plan's governance structure with whom to communicate.
    (ii) The allocation of responsibilities between those charged with governance and management.
    (iii) The plan's objectives and strategies and the related business risks that may result in material misstatements.
    (iv) Ones that those charged with governance consider as warranting particular attention during the audit and any areas for which they request additional procedures to be undertaken.
    (v) Significant communications between the entity and regulators.

(vi) Other matters those charged with governance believe are relevant to the audit of the financial statements.

j. The attitudes, awareness, and actions of those charged with governance concerning (a) the plan's internal control and its importance in the plan, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or the possibility of fraud.

k. The actions of those charged with governance in response to developments in law, accounting standards, corporate governance practices, and other related matters, and the effect of such developments on, for example, the overall presentation, structure, and content of the financial statements, including the following:

(i) The relevance, reliability, comparability, and understandability of the information presented in the financial statements.

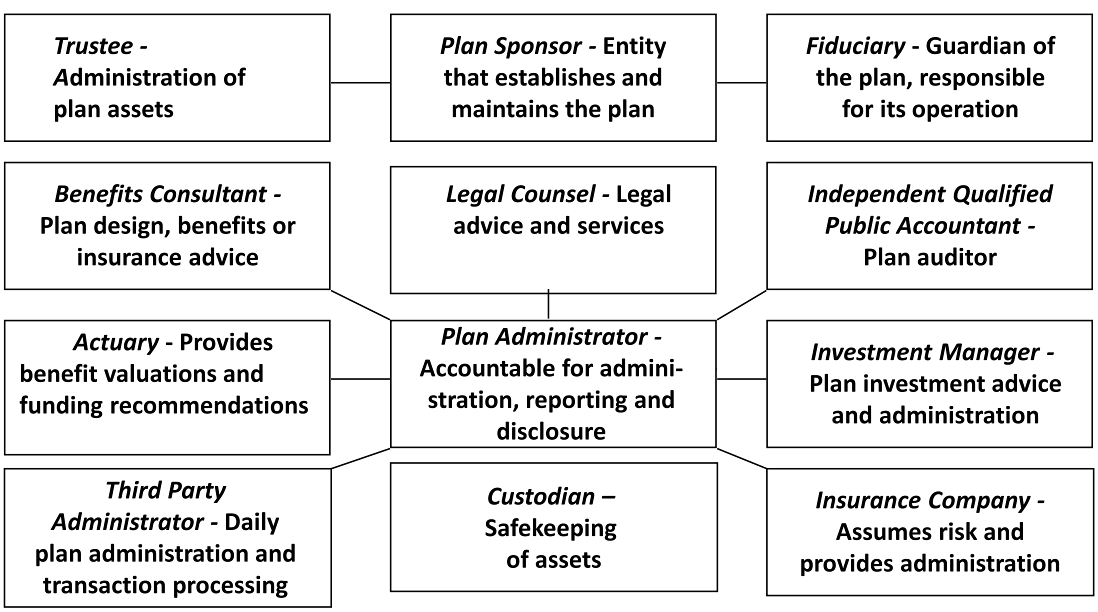
(ii) Whether all required information has been included in the financial statements, and whether such information has been appropriately classified, aggregated or disaggregated, and presented.

l. The actions of those charged with governance in response to previous communications with the auditor.

If applicable, the document or documents that comprise the annual report and the planned manner and timing of the issuance of such documents in accordance with paragraph .13 of AU-C Section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. When the auditor expects to obtain other information after the date of the auditor's report, the discussions with those charged with governance may also include the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists.

The communication with those charged with governance may be verbal or in writing. If the communication is verbal then the auditor should document how the information was communicated, to whom, the date of the communication, and the nature of the information discussed.

D. Identification of parties in interest



All parties in interest must be identified to all members on the engagement team in order to identify any prohibited transactions between the plan and a party in interest. A party in interest is defined as one of the following:

a. Fiduciaries or employees of the plan;
b. Service providers for the plan, including the plan's legal counsel and the audit firm;
c. Employer whose employees are covered;
d. Employee organization (union) whose members are covered by the plan;
e. A person who owns more than 50 percent of the previously stated employer; or
f. Relatives of the above.

Once the parties in interest have been identified, the auditor should inquire of the plan administrator to determine if the plan has engaged in a prohibited transaction with a party in interest. Prohibited transactions are required to be disclosed in the financial statements and included on the Form 5500 supplemental Schedule of Non-exempt Transactions. Furthermore, prohibited transactions are also subject to excise tax.

There is no concept of materiality when it involves a prohibited transaction with a party in interest.

Specifically defined prohibited transactions with a party in interest include:

a. A direct or indirect sale;
b. Exchange or lease of property;
c. Lending of money or other extension of credit;
d. Furnishing of goods or services or facilities; and
e. Transfer of plan assets to a party in interest for the benefit of that party in interest.

If any of these activities occur with a party in interest, then the transaction should be disclosed and reported accordingly on the appropriate supplemental schedule.

Certain transactions with parties in interest are exempt from being reported as a prohibited transaction. Administrative fees paid by the plan, other fees and expenses paid by the Plan Sponsor, the audit firm performing the benefit plan audit, the legal counsel providing services to the Plan are examples of exempt transactions. The auditor should perform procedures to identify the parties in interest such as inquiring management, reviewing the prior year Form 5500 and audited financial statements, obtaining and reading all agreements with service providers, reading the minutes to board meetings, etc.

E. Brainstorming sessions

The clarified auditing standards require a brainstorming session related to financial statement risks and potential fraud risks for audit engagements. The auditor may decide to combine the brainstorming efforts for both potential fraud and financial statement risks into one general brainstorming session in order to increase efficiencies in the audit process. Auditors should consider the general brainstorming session in order to document risks associated with benefit plan audits, investment activity, plan operation and administration, fraud risks, current market activity, changes in the plan document, and/or service provider agreements. When documenting the brainstorming session, the audit engagement team should be identified as well as any engagement specific risks. However, some auditors do perform and document their brainstorming sessions individually for the financial statement risks and fraud risks.

The planning stage of the audit includes obtaining an understanding of the plan and its control environment, conducting brainstorming sessions with the engagement team, performing preliminary analytical review procedures, communication with those charged with governance and the identification of parties in interest, and specific audit risks. When the auditor considers the timing of the audit engagement and scheduling with the client, sufficient time should be allotted to the planning phase. It is recommended that the auditor schedule one to two days, as necessary, for planning prior to the start of fieldwork. The auditor should strive to complete the planning procedures as well as select samples for the specific audit areas at the beginning of the audit which should lead to a more efficient and effective audit.

F. Identification of risks

The auditor's risk identification and assessment process is iterative and dynamic. In obtaining the understanding required by SAS No. 145, initial expectations of risks may be developed and may be further refined as the auditor progresses through the risk identification and assessment process.

To assist auditors in understanding the requirements related to the identification and assessment of the risks of material misstatement, SAS No. 145 clarifies various requirements and introduces new concepts and definitions.

1. Inherent risk factors

Inherent risk factors are characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be quantitative or qualitative and include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is referred to as the *spectrum of inherent risk*. The spectrum of inherent risk provides a frame of reference in determining the significance of the combination of the likelihood and magnitude of a misstatement.

Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion's susceptibility to misstatement, which, in turn, facilitates a more focused identification of risks of material misstatement at the assertion level. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement assists the auditor in assessing inherent risk, which also informs the auditor's design of further audit procedures in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. It is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk.

2. Relevant assertions

The definition of a relevant assertion was revised to clarify that an assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement, taking into account the likelihood and magnitude of a misstatement. A risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).

During the planning phase, the auditor will be obtaining various information related to the plan and its environment as well as risks associated with administration and operation of the plan. These risks must be identified and documented in order to properly assess the risks that may have an impact on the financial statements. Therefore, the auditor should be familiar with the risks associated with a benefit plan audit as well as the specific risks associated with defined contribution plans.

Audit risk factors for various types of benefit plans include, but are not limited to, the following:

a. Plan management characteristics and integrity such as participating in prohibited transactions with parties in interest, changing trustees or custodians, ignoring DOL rules and regulations;
b. Plan management's overall commitment to accurate financial reporting; the control environment that includes the condition of personnel records or lack thereof and lack of concern in regard to financial reporting;
c. The impact of computers on plan operation and administration; the structure of plan management such as inappropriate supervision and communication and a lack of an audit committee;
d. The nature of the plan;
e. External influences possibly affecting the plan;
f. Financial results of the plan sponsor and the plan;
g. Nature of the audit engagement, such as a first-year audit;
h. Valuation of hard-to-value investments not at fair value;
i. Disclosure of hard-to-value investments not sufficient;
j. New accounting guidance not presented and disclosed in accordance with GAAP;
k. Significant transactions processed by outside service organization and there is no SOC 1 SM report available; and
l. Engagement history.

Specific risks associated with defined contribution plans include:

a. Individual participant account balance activities and reconciliations;
b. Hard-to-value investments;
c. Disclosure requirements;
d. Significant transactions that are processed by an outside service provider that does not have a service organization control report, or the report contains qualifications or carve-outs that are excluded from the scope of the SOC report;
e. Employee and/or employer contributions that are incorrect because the plan sponsor did not use the correct definition of compensation in accordance with the plan document;
f. Untimely remittance of amounts withheld from employees' wages; and
g. Individual account balances that are not maintained when there is a change in service providers.

In addition to the benefit plan risk factors discussed above, the auditor must also comply with the requirements of AU 316, originally issued as SAS 99, *Consideration of Fraud in a Financial Statement Audit*, now clarified as AU-C 240. Misstatements from fraudulent acts and errors include the misappropriation of assets and fraudulent financial statement reporting.

There are typically three factors that are present when fraud occurs:

a. Incentive/pressure;
b. Opportunity; and
c. Attitude/rationalization.

AU-C 240 requires the plan auditor to inquire of plan management, employees of the plan sponsor, the internal audit department (if applicable), etc. The auditor should inquire regarding the person's knowledge of fraud or misappropriation of assets and the process of notifying the appropriate level of management about unusual items or irregularities.

A sample of fraud risk factors include:

a. Financial stability or profitability of plan sponsor.
b. Limited investment options.
c. Poor investment results.
d. Significant related-party transactions not in the ordinary course of business.
e. Non-readily marketable investments where valuation is based on significant estimates.
f. Lack of oversight by plan management on outside service providers.
g. Domination of plan management by a single person or small group without compensating controls.
h. Lack of competence of plan trustees due to background and lack of training.
i. Inadequate monitoring of controls.
j. Ineffective communication, implementation, support or enforcement of plan sponsor's or plan's values or ethical standards by management.
k. Plan administrator lacks an understanding of the major regulations that govern the plans.
l. Disputes between current or predecessor auditor on accounting, auditing, or reporting matters.

Systems of Internal Control

Systems of Internal Control

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Understand the components of systems of internal control;
- Identify various ways that auditors can document their understanding of the systems of internal control at both the plan sponsor and the service organizations; and
- Read and interpret the controls covered by the service organization control report.

I. Components of systems of internal control

There are six main components of systems of internal control for defined contribution plans, and they are no different from the system of internal control components for a financial statement audit. The components include the control environment; risk assessment; control activities; information and communication; monitoring; and communication of control deficiencies to those charged with governance. Listed below is a brief description of each component.

a. **Control environment** – Attitudes and awareness of plan management and administrator.
b. **Risk assessment** – Identification, analysis, and management of specific risks.
c. **Control activities** – Policies and procedures to ensure that the plan directives are followed.
d. **Information and communication** – Methods established to record, process, summarize, and report plan transactions.
e. **Monitoring** – Assessments of quality of internal control performance over time.
f. **Communication of control deficiencies** – Communication of control deficiencies to those charged with governance.

A. Understanding and documenting the plan's systems of internal control

As discussed in the previous chapter, the key elements in obtaining an understanding of the plan and its environment include:

a. Industry, regulatory, and external factors;
b. The nature of the entity;
c. The entity's objectives, strategies, and related business risks; and
d. The entity's financial performance.

In addition to the components above, an auditor must also obtain an understanding of the system of internal controls at the plan sponsor and the service organization. How the auditor obtains this understanding is based entirely on the judgment of the auditor. The auditor may utilize their understanding of the plan and its environment to enhance their understanding of the system of internal controls. Other procedures that should be considered include making inquiries of the plan administrator, examining the plan document and amendments, and determining the location of plan assets, accounting records, as well as the party responsible for the controls.

Due to the fact that there may be more than one service provider associated with the plan, the plan records may be located at multiple locations. Therefore, it is imperative that the auditor determine the exact location of the accounting records and the parties responsible for the controls at each location. For example, the contribution records for the employees and the employer may be accounted for by the plan sponsor as well as the trustee and/or custodian as well as the third party recordkeeper. The plan sponsor would be responsible for collecting employee deferrals and participant loan payments, matching employee contributions, and then transmitting payments to the service provider. Contribution records may also be located at the service provider who is responsible for receiving the payment and allocating the amounts properly between employee and employer amounts to the individual participant accounts. Therefore, the detailed accounting records would be maintained at both locations.

There are numerous transactions and activities that occur in the operation and administration of an employee benefit plan. Auditors must document their understanding of the controls surrounding the accounting records for everything from the enrollment forms to distribution requests. For example, if employees enroll in the plan via hard-copy enrollment forms and indicate the deferral amount to be withheld and investment allocations, then the hard-copy forms would be maintained at the plan sponsor. However, some service providers and plan sponsors allow employees to enroll electronically and there is no hard-copy document. The auditor would need to obtain an understanding of the controls related to the electronic enrollment process in order to properly design the audit procedures. Records for other electronic transactions such as changes in deferral amounts, investment allocations, and distribution requests would be maintained by the service provider and the auditor would still need to obtain an understanding of the controls related to these activities.

Once the auditor has identified the location of the accounting records, the next step is to identify the key control areas that need to be examined further. For the majority of benefit plans, the key control areas typically include:

a. Contributions and receivables.
b. Disbursements and payables.
c. Investments.
d. Payroll.
e. Financial reporting.

The plan auditor should focus on these key areas in order to properly document the understanding of system of internal controls and to determine if the controls appear to be properly designed and implemented. The plan auditor should obtain a description of the controls and the individuals responsible for each area. This information is usually provided by the plan sponsor in one of the following formats: memorandum, flow chart, or checklist. Memorandum format is probably the most popular form of obtaining these control descriptions. The auditor can interview the individuals identified in the controls in order to properly identify the key controls for that area. Once the documentation has been obtained, then the auditor should perform procedures to determine if the controls are properly designed and implemented. During these procedures, auditors may identify significant deficiencies and material weaknesses that will be reported in the required communication regarding deficiencies in systems of internal control.

Discussion question:

> How can auditors determine whether the system of internal controls at the plan sponsor are properly designed and implemented?

Walk-through procedures generally include inquiry, observation, and recalculation. The auditor must document the individuals that were interviewed, their title, the issues discussed, and the responses received. Auditors may also observe employees at the plan sponsor performing their daily activities.

As noted above, auditors must use their judgment when it comes to documenting their understanding of system of internal control. Various examples of memos, narratives, checklists, and flowcharts are noted below for discussion. All the following examples are excerpts from internal control documentation samples and do not reflect a complete representation.

	Addresses Fraud or Significant Risk?	**Control Has Been Implemented?**	**Automated or IT-dependent?**	**Effectively Designed?**	**Test Control?**	**Comments**
Principle: The plan demonstrates a commitment to integrity and ethical values.						
A process exists by which those charged with governance are made aware of key developments that may affect financial reporting.						
A code of conduct or ethics policy exists.						
Management, employees, the plan sponsor, plan administrator, and others are made familiar with the plan's policies and practices with regard to ethics, accepted business practices, and a positive control environment.						
Management acts to remove or reduce incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.						
Management sets realistic financial targets and expectations.						
Management follows ethical guidelines in dealing with external audiences, including participants, investment advisors, actuaries, trustees, etc.						
Relationships with professional third parties are periodically reviewed to ensure that the plan maintains association with reputable parties.						

	Addresses Fraud or Significant Risk?	Control Has Been Implemented?	Automated or IT-dependent?	Effectively Designed?	Test Control?	Comments
“Risk appetite,” or the amount of risk the plan is willing to accept, associated with each new activity is discussed and influenced by the plan’s culture and operating practices.						
Management exemplifies attitudes and actions in line with its mission, vision, and values to support an effective control environment.						
Management gives appropriate attention to internal controls and corrects any known weaknesses in internal controls on a timely basis.						
Management regards the accounting function as a means for monitoring and exercising control over the plan’s various activities.						
Management adopts accounting policies that are appropriate for the plan and consistent with GAAP (or a special purpose framework).						
Management sets the tone that high-quality and transparent financial reporting is expected.						
Management establishes human resource policies and procedures that demonstrate its commitment to integrity, ethical behavior, and competence.						
Employee recruitment and retention practices for key financial positions are guided by principles of integrity and by the necessary competencies associated with the positions.						
There are formal policies and procedures to evaluate employee performance and compensation.						

	Addresses Fraud or Significant Risk?	Control Has Been Implemented?	Automated or IT-dependent?	Effectively Designed?	Test Control?	Comments
Job performance and competencies are periodically evaluated and reviewed with each employee.						
Principle: The board of trustees or other plan oversight committee demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting.						
The makeup and general construction of the board of trustees and/or plan investment and administrative committees are appropriate and adequate given the nature of the plan.						
Those charged with governance are sufficiently involved with the plan to address important oversight responsibilities.						
The board of trustees and/or plan investment and administrative committees is (are) sufficiently independent of management so that necessary questions are raised.						
Those charged with governance provide input and oversight of the plan's financial statements, including the application of GAAP (or a special purpose framework) and use of accounting judgments.						
A process exists by which those charged with governance are made aware of key developments that may affect financial reporting.						

Once the auditor documents their understanding of the entity level controls for the control components, the activity level controls must also be documented for the pertinent audit areas such as contributions, participant data, benefit payments, notes receivable from participants, etc.

The following example is related to the **controls for participant data and employee contributions but does not reflect a complete understanding of the relevant controls**.

	Assertions	Addresses Fraud or Significant Risk?	Control Has Been Implemented?	Automated?	Effectively Designed?	Test Control?	Comments
Maintaining Participant Data							
The plan instrument defines eligibility for plan participation.	A/CL						
Procedures exist to promptly identify employees who become eligible to participate in the plan, for example, by accumulation and periodic review of data relevant to eligibility such as age and service hours.	E/O, C, A/CL						
Employees who become eligible to participate in the plan are promptly notified of their eligibility.	E/O						
Enrollment applications are retained and numerically controlled.	E/O, C						
Enrollment applications are reviewed for eligibility and approved by a responsible official.	E/O, C, A/CL						
A record is kept of employees who decline to participate, for example, by retaining their signed refusals.	A/CL, C						

	Assertions	Addresses Fraud or Significant Risk?	Control Has Been Implemented?	Automated?	Effectively Designed?	Test Control?	Comments
There is adequate segregation of duties among those who: a. Maintain participant data records; b. Process the data records; and c. Approve benefits.	E/O, A/CL						
Participant data records are maintained in a secure place to which access is limited to authorized persons.	E/O						
Participant data is periodically reconciled to the employer's (or participating employers' in a multiemployer plan) payroll and personnel records.	E/O, A/CL, C						
Participants are given statements of their account balances and benefit data upon written request.	A/CL						
The plan allows participants to access their account balances and initiate transactions in an electronic means (such as the internet or intranet).	A/CL						
Withdrawal forms are numerically controlled.	C						

If the auditor does not want to utilize the checklist or tabular format, another option would be to document their understanding in the form of a memo or narrative. This memo can be provided to the plan sponsor in order to provide a starting point for documentation of the controls that are in place at their organization.

The plan sponsor can simply drop in the name of the person responsible for the control or make changes as necessary to reflect the policies and procedures they currently follow.

A word of caution!! Please be aware that a common tendency when using memos and narratives is to focus on the process and not the actual control. Therefore, it is imperative that the auditor understands the actual controls that are in place at the plan sponsor regarding plan activity. A sample narrative is presented below.

Sample narrative:

Participant Information
When a new employee is hired, they are provided with an enrollment package. Eligibility status and deferral election is maintained by ________________. Participants can enroll in the plan by completing an enrollment form that includes their deferral amount and fund allocations or through an online enrollment process. Participants can change their deferral percentage by completing a form that is approved by ___________________________, Plan Administrator, or participants can change their deferral through a secure portal with the service provider. If participants change deferral election over the internet or via telephone and the Plan Sponsor is notified of changes through e-mail, then please document how often the Plan Sponsor is notified and whether or not the communications are maintained in a central location or the employee's file. Who is responsible for updating the payroll system for changes in deferrals?

Employees can change their investment allocations either by phone or internet. The employees are given a confirmation number and are notified with a statement showing the changes made will be sent to them by mail. The notice is sent to the participant. Human Resources and Accounting can access the same information from the Service Provider website.

Investment income allocated to participant accounts will be included in the SOC 1 Type 2 report.

The plan administrator has obtained a valid certification from an eligible institution and has instructed the plan auditor to perform an ERISA 103(a)(3)(C) audit for the year ended December 31, 20X5. Therefore, an understanding of the system of internal controls related to investments and investment related income at the plan level is not necessary.

Participants can apply for a loan by completing the loan application form in hardcopy or via an online process. All loans have to be approved by __________. After a loan has been approved, _________ is responsible for updating the payroll system for the loan payments. If the loan process is completed through online procedures, __________ updates are sent to ______ via email in order to properly update the payroll.

Payroll Information
Is payroll outsourced? ____________________; how is information transferred to payroll company; how are employees paid; who updates salary changes; bonuses; Who is responsible for updating the payroll system for changes in deferrals? How is the payroll system secured? Who has access to payroll information?

Contributions and Loan Payments
Employee contributions and loan payments are withheld from each paycheck and the employer match is calculated for every payroll. A wire transfer is sent to ____________ on the same date as the payroll check date. ____________ is responsible for preparing the wire transfer, ______approves the amount to wire and ____________ performs that actual transfer of funds. A confirmation is received from the service provider and maintained by ________________.

Forfeitures of employer contributions resulting from termination of a participant before full vesting are used to reduce future employer contributions.

Distributions
Participants can request a distribution from the plan via the online process or by completing a distribution request form. All distributions from the Plan must be approved by _________, Plan Administrator. _________________________ receives a distribution election form from the participant, verifies eligibility, verifies the vesting information and if approved, processes the request.____________ processes all termination or withdrawal information and sends a check to the participant (or checks are sent directly to the participants by the service provider).

Hardship Withdrawals
The plan allows hardship withdrawals. Hardship withdrawals are requested by the participant and must be approved by ___________, Plan Administrator. If approved, then the check is distributed to the participant by the service provider (or plan sponsor). At this time, ______________ updates the payroll system in order to stop all future elective contributions to the Plan.

Administrative Expenses
All administrative expenses are paid by the Plan Sponsor with a check on a quarterly basis after an invoice is received from the service provider (or the fees are deducted from plan assets).

1. Understanding the components of the entity's system of internal control

When identifying controls that address the risks of material misstatement, SAS No. 145 clarifies the requirement to evaluate the design and determine the implementation of certain controls within the control activities component. These controls include the following:

a. Controls over significant risks;
b. Controls over journal entries and other adjustments as required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*;
c. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and
d. Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

As described further in the text that follows, SAS No. 145 also requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

The controls for which the auditor is required to evaluate design and determine implementation are referred to as *identified controls* in SAS No. 145. Such controls might also be referred to as *relevant controls* or *key controls* in some audit methodologies.

2. Risks arising from the use of IT and general IT controls

SAS No. 145 now defines the terms *risks arising from the use of IT* and *general IT controls*. SAS No. 145 requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. To identify the risks arising from the use of IT, the auditor identifies the IT applications and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risks of material misstatement at the assertion level, as described in the preceding table under “control activities.” Appendix E, “Considerations for Understanding IT” of SAS No. 145 includes guidance that may be relevant in identifying IT applications and other aspects of the IT environment that may be subject to risks arising from the use of IT.

After completely documenting their understanding of system of internal controls, the auditor should perform a walk-through related to significant or material controls. The walk-through procedure must also be documented. One of the purposes of the walk-through is to determine whether or not the control has been implemented. A walk-through in this regard is not a test of control that would test to see if the control were designed and operating effectively. The walk-through is meant to assist the auditor in identifying potential deficiencies or weaknesses in the system of internal control because the control was not implemented.

Auditors must obtain an understanding of the system of internal controls and determine whether or not the control has been implemented regardless of whether or not the auditor is going to rely on the controls. At this point, it should also be noted that the auditor is not required to test controls for operating effectiveness. However, in some situations, auditors may determine that by testing the controls in place at the plan sponsor, the substantive test of details may be reduced.

B. Control testing

If the auditor determines that the controls at the plan sponsor appear to be properly designed and implemented through the documentation noted above and the initial walk-throughs, then a decision to test the controls for operating effectiveness may be performed to reduce the substantive testing later in the audit. Auditors would test the controls directly related to preventing or detecting misstatements in the financial statements.

If a control was tested in a prior year and found to be operating effectively, then the auditor should indicate the specific inquiry, observation, and inspection procedures that were performed during the current year to determine whether conditions affecting performance of the control have significantly changed that would then necessitate retesting in the current year. If the control has changed since the previous audit or mitigates a fraud risk or other significant risk, then as a result, the control would need to be retested.

Control testing may be performed at the end of the year or at an interim period. If a control was tested at an interim date, describe the additional evidence, if any, that the auditor obtained for the remaining period of reliance, including whether there were any significant changes in the system of internal control subsequent to the interim period.

As noted above, controls are not required to be tested; therefore, auditors need to use their judgment and knowledge of the plan to determine whether or not to test the controls and when. However, if the auditor elects not to test controls, then the auditor must document the reasons why the controls were not tested.

C. Service organizations and their auditor reports

Due to the fact that so much of the plan’s operations and administration are usually outsourced to service providers, the auditor must also obtain an understanding of the controls in place at all of the applicable service organizations.

Due to the significance of information maintained by the trustee or custodian and/or other service provider, it is imperative that the auditor understand the controls that are in place at the service provider. In order to do this, the auditor should obtain a service organization control report (SOC) from each service provider. There are two types of SOC reports:

a. A type I SOC 1 report only describes the control policies and procedures that are in place at the service provider; and
b. A type II SOC 1 report describes the control policies and procedures that are in place as well as tests that the controls are in place and operating effectively. At a minimum, an auditor should obtain a type I SOC 1 report in order to obtain an understanding of the controls at the service provider.

In order to reduce control risk below the maximum and reduce the overall level of substantive testing, the auditor must obtain a type II SOC 1 report. Please note that the key word is “reduce” substantive testing, not eliminate! Substantive testing can NEVER be eliminated for any reason! Many auditors assume that since they have a type II SOC 1 report and/or a certification that testing procedures can be eliminated, and this is a mistake.

In order to rely on the type II SOC 1 report to reduce control risk and reduce substantive testing, the auditor must test the complementary user entity controls (CUECs). The CUECs are controls that are supposed to be in place at the plan sponsor to ensure that the controls at the service provider are working properly. The auditor can only reduce control risk for controls at the service provider. In order to reduce control risk for controls at the plan sponsor, the auditor must test the controls for operating effectiveness.

The auditor is responsible for reading the entire SOC 1 report and documenting their understanding of the policies and procedures at the service provider. It is important to determine if the SOC 1 report supports the assessed level of control risk for the plan audit and covers all of the services that the third party is providing to the plan, including new plan implementation, plan transfers, enrollments, allocation changes, participant loans, and distributions. The SOC 1 report should also include documentation on the controls related to transactions made via telephone and/or the internet. If a SOC 1 report is not available, then the auditor must perform procedures to identify, document, and understand the controls in place at the service provider. The plan sponsor may have documentation of the controls in place at the service organization or the auditor may request specific information directly from the service provider. In certain situations, the auditor may determine that it is necessary to visit the service provider in order to obtain an understanding of the controls in place. If the auditor determines that sufficient information cannot be obtained, then the auditor should issue a qualified or disclaimer of opinion on the plan’s financial statements because of a scope limitation.

The period covered by the SOC 1 report should cover at least six months of the plan year under audit. If the SOC 1 report does not cover at least six months, then the report cannot be utilized to document the auditor’s understanding of controls. A bridge letter should be obtained from the service provider that addresses the annual period not covered by the SOC 1 report. For example, if the service organization report is for the period October 1, 2024, through September 30, 2025, then the auditor must obtain assurance from the service provider that there have not been any changes in control policies or procedures for the period October 1, 2025, through December 31, 2025. The assurance may be in the form of a bridge letter or verbal communication between the plan auditor and the service provider.

There is no standard format for the SOC 1 report; it is up to the service organization and their service auditor to agree on the format. However, every SOC 1 report will include an identification of the controls in place at the service organization, the procedures performed to test the controls (for a type II audit), and any exceptions noted during the testing. The plan auditor must use their judgment in regard to the identified exceptions to determine their effect on the financial statement assertions. Furthermore, every SOC 1 will identify **specific complementary user entity controls**. These are controls that should be set in place at the plan sponsor level in order to ensure that the plan is administered properly and in accordance with the service agreement between the plan and the service provider. The plan auditor should review the user controls and determine if these controls are in place at the plan sponsor.

As mentioned above, the SOC 1 report should address voice response and internet-based recordkeeping systems. More and more service providers as well as plan administrators are offering participants the option of enrolling and making changes via voice response systems and internet-based systems. The absence of a paper trail may prevent the plan auditor from obtaining a sufficient understanding of the controls at the service organization if a type II SOC 1 report from the service organization is not obtained. Therefore, the plan auditor should ensure that the SOC 1 includes a description of the controls related to voice response and internet-based recordkeeping systems.

If there are exceptions noted in the testing by the service auditor, then the plan auditor should evaluate those exceptions to determine their impact on the reliance of the SOC 1 type II report. The exceptions are considered to be deficiencies in the system of internal control at the service provider as well as the plan itself because of the potential impact on the plan's operations and or compliance with the plan document.

In order to properly document the auditor's understanding of controls in place at the service organization, the auditor should consider completing a SOC 1 checklist. There are various SOC 1 report checklist formats available that can be tailored for each engagement. See Appendix A for a copy of the SOC 1 report checklist utilized by the AICPA's Employee Benefit Plan Audit Quality Center.

The following is a summary of the items that should be considered by the plan auditor in regard to the SOC 1 report from the service provider:

a. Service auditor's opinion;
b. Service auditor's reputation;
c. Period covered by the report and bridge letter;
d. Subservice organizations;
e. Substantive testing can never be eliminated – just reduced;
f. User controls;
g. Exceptions noted; and
h. Voice response and internet-based transactions.

Discussion question:

What, if anything, has your firm implemented in order to be more efficient in reviewing SOC reports?

D. Risk assessment

Every audit engagement must include an assessment of risks related to the nature of the plan and the entity, the industry, regulatory and external factors, as well as many other factors, in order to determine the effect on the overall audit. For each assertion being tested, there is a direct link between the assertion, the identified risks, tests performed, evidence obtained, and conclusions reached. Based on the auditor's assessed level of risk, the audit programs may be tailored to the needs and risks associated with each engagement. Risks must be identified first by audit area then on assertion level.

Risk factors include, but are not limited, to the following:

a. Plan management characteristics and integrity;
b. The overall commitment to financial reporting;
c. Management structure;
d. Control environment;
e. Impact of computers;
f. External influences affecting the plan; and
g. Business relationships and related parties.

After the auditor has identified the risks relevant to plan, then the auditor should assess the risks by audit area for each relevant assertion. Audit assertions can be categorized into one of the following categories:

a. Occurrence/existence;
b. Rights and obligations;
c. Completeness;
d. Accuracy/valuation and allocation;
e. Cut-off; and
f. Classification and understandability.

The auditor must assess the inherent risk, control risk, and combined risk for each audit area at the assertion level. The risks are defined below and are assessed as high, medium, or low.

a. **Inherent risk** – Based on what is considered normal for that particular account or activity.
b. **Control risk** – Is directly related to the reliability of data being tested.
c. **Combined risk** – The risk of material misstatement; combination of inherent and control risk.

AU-C Section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, requires that when designing and performing audit procedures, the auditor should consider relevant plan provisions that affect the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. The relevant plan provisions will vary for each type of plan and the circumstances of each engagement. When designing audit procedures, the testing of relevant plan provisions may be coordinated among the various audit areas to which they relate.

The following are some examples of plan provisions often included in a plan instrument by audit area (this list is not all-inclusive):

a. Individual participant accounts:
    (i) Participation and eligibility requirements;
    (ii) Types of contributions and distributions;
    (iii) Timing of contributions;
    (iv) Contribution limitations;
    (v) Investment of contributions;
    (vi) Allocations to participant accounts;
    (vii) Forms of distributions;

(viii) Benefit commencement dates;
(ix) Vesting and forfeitures;
(x) Service requirements and credits;
(xi) Participant loans;
(xii) Transfers; and
(xiii) Administration of the plan.

b. Contributions and contributions receivable:
   (i) Participation and eligibility requirements;
   (ii) Types of contributions;
   (iii) Timing of contributions;
   (iv) Contribution limitations;
   (v) Investment of contributions;
   (vi) Use of forfeitures;
   (vii) Service requirements and credits; and
   (viii) Allocations to participant accounts.

c. Distributions and related obligations:
   (i) Eligibility requirements (distributable events);
   (ii) Types of distributions;
   (iii) Forms of distribution;
   (iv) Benefit commencement dates;
   (v) Determination of benefits;
   (vi) Vesting;
   (vii) Service requirements and credits; and
   (viii) Allocations to participant accounts.

d. Claims (in a health and welfare plan):
   (i) Eligibility requirements;
   (ii) Types of claims;
   (iii) Claims coverage; and
   (iv) Determination of claims.

e. Loans to participants:
   (i) Eligibility requirements;
   (ii) Loan terms; and
   (iii) Allocations to participant accounts.

f. Investments and investment income:
   (i) Investment of contributions;
   (ii) Administrative provisions;
   (iii) Direction of investments; and
   (iv) Allocations to participant accounts.

g. Expenses:
   (i) Administrative provisions; and
   (ii) Allocations to participant accounts.

Because of the nature of ERISA plan engagements, it would be rare for the auditor, based upon the assessed risks of material misstatement at the relevant assertion level, not to test any relevant plan provisions.

The auditor’s assessment of the risk of material misstatement for each relevant assertion of each significant account balance, class of transactions, or disclosures should affect the design of planned audit procedures and is a matter of the auditor's professional judgment.

Appendix A

AICPA Employee Benefit Plan Audit Quality Center

Documentation of Use of a Type 2 Service Auditor's Report in an Audit of an Employee Benefit Plan's Financial Statements

PLAN NAME:	CLIENT NUMBER:
PLAN YEAR END:	NATURE OF PLAN AUDIT: ERISA_____ ERISA 103(a)(3)(C)_____

Note:

This non-authoritative tool is intended to assist CPAs auditing the financial statements of employee benefit plans that use one or more service organizations (user auditors). It is designed to assist user auditors in documenting their procedures and findings related to controls at a service organization that are likely to be relevant to the employee benefit plan's internal control over financial reporting. It focuses on the user auditor's use of a "report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls" (a type 2 report). Both a type 1 report and a type 2 report provide a user auditor with information about the design and implementation of controls at a service organization that are likely to be relevant to user entities' internal control over financial reporting. Such information is intended to provide the user auditor with a basis for identifying and assessing the risks of material misstatement in the employee benefit plan's financial statements related to the services provided by the service organization. A type 2 report also includes a description of the service auditor's tests of the operating effectiveness of controls and the results of those tests. That information should enable the user auditor to determine whether he or she can rely on the operating effectiveness of the controls that were tested for the purpose of determining the nature, timing and extent of substantive procedures on related account balances, classes of transactions, and disclosures in the employee benefit plan's financial statements.

The AICPA has introduced a series of three Service Organization Control (SOC) reports. Service auditors' reports that address controls at a service organization relevant to user entities' internal control over financial reporting are referred to as SOC 1 reports; for example, a report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls is referred to as a type 2 SOC 1 report. SOC 1 engagements are performed under SSAE No. 16, Reporting on Controls at a Service Organization, and the related reports are referred to as SOC 1 reports.

This tool is not intended to be used as an audit program or to provide authoritative guidance and should be tailored to the user audit or firm's employee benefit plan audit practice and the circumstances of the individual plan audit. Certain sections of this tool may be completed by the user auditor firm's reviewer (if applicable) to document the use of a type 2 SOC 1 report in an audit of an employee benefit plan's financial statements while other sections may be prepared by the engagement team to document procedures performed to evaluate controls at a service organization. For purposes of this tool, the plan auditor is the user auditor.

Section I – Type 2 SOC 1 Report General Information

NAME OF SERVICE ORGANIZATION
NAME OF SERVICE AUDITOR
SERVICES PROVIDED BY THE SERVICE ORGANIZATION
LOCATIONS COVERED (IF APPLICABLE)
PERIOD COVERED BY THE TYPE 2 SOC 1 REPORT

Section II – Service Auditor's Opinion

What type of opinion did the service auditor express in the type 2 SOC 1 report?

______ Unqualified
______ Qualified

If qualified, document the nature of the qualification(s), and any potential effect it may have on the risk of a material misstatement in the employee benefit plan's financial statements in the box provided below. Note that a qualification may affect a single control objective (e.g., controls related to enrollment) or may affect several control objectives (e.g., IT general controls over logical access.)

Section III – Period Covered by the Type 2 SOC 1 Report

Does the type 2 SOC 1 report cover the period covered by the plan's financial statements that are being audited?

_____ Yes (skip to Section IV)

_____ No

If the type 2 SOC 1 report does not cover a significant portion of the period covered by the plan's financial statements, was evidence about the operating effectiveness of controls obtained for the period that is not covered by the type 2 SOC 1 report by performing additional procedures?

Examples of procedures that may be performed include:

- Making inquiries of the service organization about any major changes in the controls or processes, any noted issues, or any changes in programs or software at the service organization since the period covered by the service type 2 SOC 1 report.

(***Note:*** Some service organizations provide a "bridge letter" that addresses the period from the date of the service auditor's report through the most recent calendar year end.)

Name of service organization representative contacted:

Telephone number: _____

Date contacted: _____

Contacted by: _____

Results: _____

- Reviewing documentation and correspondence issued by the service organization to management regarding changes to the programs, software, or controls or any noted issues.
- Obtaining additional audit evidence regarding the operating effectiveness of controls at the service organization for the portion of the period that is not covered by the type 2 SOC 1 report. If the plan auditor believes it is necessary, he or she may request that the user organization (plan) contact the service organization to request that the service auditor perform agreed-upon procedures at the service organization or the plan auditor may perform such procedures.

Conclusion:

Document the plan auditor's conclusion and any procedures performed, as applicable and include any supporting documentation.

Section IV – Service Auditor’s Professional Reputation

If the plan auditor is unfamiliar with or has no experience with the service auditor that issued the type 2 SOC 1 report, the plan auditor should perform procedures concerning the service auditor’s professional reputation. Examples of procedures could include reviewing on-line sources of such information such as the Public Company Accounting Oversight Board’s (PCAOB) website, which includes registration listings and inspection reports; the AICPA’s website from which peer review reports and peer review acceptance letters can be accessed; and the website of the applicable state accountancy board. If no information can be found, document that fact, and determine the effect on the audit.

Was the service auditor’s report prepared by a CPA firm with whom the plan auditor is familiar?

_____ Yes (skip to Section V)

_____ No

Document procedures performed and include any supporting documentation.’

Section V – Use of Subservice Organizations / Carve-Outs

Did the service organization outsource any functions relevant to the plan’s internal control over financial reporting to another service organization (a subservice organization), and was the subservice organization carved out of the type 2 SOC 1 report?

_____ Yes

_____ No (skip to Section VI)

If yes, in the table below, list the names of the subservice organizations and the functions performed by the subservice organizations identified in the service auditor‘s type 2 SOC 1 report (and also in the description of the service organization’s systems.) (If the service auditor’s report uses the carve-out method, the functions performed by the service organizations will be provided but the names of the subservice organizations may not be provided.) If the functions performed by the subservice organization are significant and relevant to the plan’s internal control over financial reporting, the plan auditor may consider obtaining additional information about the subservice organization’s controls. Such information may be available from user manuals, system overviews, technical manuals, the contract between the plan and the service organization, and reports on the subservice organization’s controls, prepared by other service auditors, internal auditors, or a regulatory authority.

Complete column 3 to document or reference work performed to address the carved-out subservice organization(s). If the controls and functions performed by the subservice organization are not deemed relevant or significant to the plan's internal control over financial reporting, indicate N/A.

Name of Subservice Organization	Functions Performed	Work performed to address Carved-out Subservice Organization

Section VI – Identification of Control Objectives and Deviations Noted

In this section, the plan auditor will begin to note the control objectives to determine what is present and what is not, and any noted deviations identified in the results of tests of controls that may affect the nature, timing and extent of audit procedures in an employee benefit plan audit. List below the control objectives included in the description of the service organization's system.

Control objectives included in the service organization's description of its system		Were deviations noted in the service auditor's description of tests of controls and results?		Page(s) #(s) in service organization's description or service auditor's description of tests of controls where control objective is located
Controls provide reasonable assurance that:		Yes*	No	
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

* For any yes answers, complete the table below.

In the table below, summarize the service organization's and plan auditor's response (if any) to any deviations identified by the service auditor in the description of tests of controls and results. *Note: Deviations in the results of tests of controls should be considered individually and, in the aggregate, to determine their effect, if any, on audit procedures to be performed.*

Control Objective # (from table above)	Deviation(s) noted	Service Organization's Response included in the description of the Service Organization's System (Such responses are not covered by the service auditor's opinion)	Plan Auditor's Response (see note below)

Note: Consider any mitigating controls in place at the plan sponsor or consider designing procedures to address the risks related to the deviations identified in the table above.

Conclusion:

_____ Deviations were noted as documented above; however, we have concluded that they would not significantly affect the nature, timing and extent of our procedures in the audit of the employee benefit plan.

_____ Although the deviations did not result in a qualification of the service auditor's opinion on the operating effectiveness of the controls to achieve the control objective, the following procedures were completed by the plan auditor to address and evaluate the effect of the deviations on the audit.

Document procedures performed and include any supporting documentation.

Section VII – Complementary User Entity Controls

Summarize any complementary user entity control considerations identified in the service organization's description of its system.

No.	Complementary user entity control considerations identified in the service organization's description	Are the Complementary user entity control considerations identified in the service organization's description relevant to the plan? If No, document below. If Yes, document or reference work performed to ensure complimentary user entity controls are in place	Work paper reference (see note below)
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			

Note: Consider completing the evaluation of the plan sponsor/plan's controls first. For controls already reviewed and evaluated by the plan auditor, insert the work paper reference where that work is documented. If the plan or plan sponsor has not implemented complementary user entity controls, then that should be documented, as well as the effect on the nature, timing and extent of audit procedures.

Section VIII – Documentation of Evaluation of the Control Objectives

If the type 2 SOC 1 report covers only the payroll process, skip Section VIII and go to Section IX.

In the following section, the reviewer or plan auditor can begin to evaluate whether the service organization's description of its system contains controls and control objectives relevant to the assertions included in the employee benefit plan's financial statements. (These are documented in columns #1 and #2 in the table below). In addition, the plan auditor will need to evaluate whether the tests of controls performed by the service auditor and the results of those tests provide sufficient appropriate evidence of the operating effectiveness of the controls to support the auditor's risk assessment.

The plan auditor should consider the following factors in making that evaluation:

a. The nature, timing, and extent of the testing. For example, when testing controls, the service auditor should perform procedures in addition to inquiry, as required by related risk assessment standards; and
b. Results of the tests of controls (e.g., any noted deviations).

Evaluation of the Control Objectives

Page # in the service organization's description of its system or service auditor's tests of controls where control objective is listed (from Section VI)	Control objective as listed in the description (from Section VI)	Does the description of the controls and the control objectives enable the plan auditor to evaluate the design and confirm the implementation of relevant controls and assess risk? (Yes/No)	Do the tests of operating effectiveness and results of those tests support the achievement of the stated control objective? (Yes/No) Note: Consider the effect of any deviations identified in the table above in Section VI	Reference from Section VII to complementary user entity controls identified in the description that are in place to support the plan auditor's risk assessment
IT General Controls/Control Objectives – Logical Access and Program Change Management				
Controls/Control Objectives Related to New Plan Set-up – Plan Provisions				
Controls/Control Objectives Related to New Plan Set-up – Participant Level Data/Accounts and Investments				
Controls/Control Objectives Related to Eligibility, Enrollment and Participant Data				
Controls/Control Objectives Related to Contributions – Plan Level				
Controls/Control Objectives Related to Contributions – Participant Level				
Controls/Control Objectives Related to Participant Account Income/Expense Allocations				
Controls/Control Objectives Related to Distributions to Participants/Beneficiaries				
Controls/Control Objectives Related to Distributions – Plan Expenses				
Controls/Control Objectives Related to Marketable Securities Held – Safekeeping & Valuation				
Controls/Control Objectives Related to Non-readily Marketable Securities Held – Safekeeping & Valuation				

Evaluation of the Control Objectives (Continued)

Page # in the service organization's description of its system or service auditor's tests of controls where control objective Is listed (from Section VI)	Control objective as listed in the description (from Section VI)	Does the description of the controls and the control objectives enable the plan auditor to evaluate the design and confirm the implementation of relevant controls and assess risk? (Yes/No)	Do the tests of operating effectiveness and results of those tests support the achievement of the stated control objective? (Yes/No) Note: Consider the effect of any deviations identified in the table above in Section VI	Reference from Section VII to complementary user entity controls identified in the description that are in place to support the plan auditor's risk assessment
Controls/Control Objectives Related to Investment Transactions – Purchases/Sales (Including realized gain/loss)				
Controls/Control Objectives Related to Investment Income – Plan Level				
Controls/Control Objectives Related to Report Processing – Plan Level				
Controls/Control Objectives Related to Report Processing – Participant Level				
DEFINED CONTRIBUTION PLANS ONLY				
Controls/Control Objectives Related to Participant Loans (Authorization, Calculation and Recording)				
Controls/Control Objectives Related to Participant Loan Repayments – Plan Level				
Controls/Control Objectives Related to Participant Loan Repayments – Participant Level				
Controls/Control Objectives Related to Investment Election Changes and Transfers				
DEFINED BENEFIT AND HEALTH & WELFARE PLANS				
Controls/Control Objectives Related to Participant Census Data				
Controls/Control Objectives Related to Plan Obligations				
HEALTH & WELFARE PLANS ONLY				
Controls/Control Objectives Related to Claims Processing				

Section IX – Payroll Processing Service Organizations

Most large payroll processors provide a type 1 or type 2 report, but such reports vary widely as to what services are covered. In addition, some payroll processors issue several reports that cover different locations, services or markets. Plan sponsors may contract with different payroll processors to provide different services. Plan sponsors are expected by the payroll processors to have controls in place to ensure accurate input and submission of data to the payroll processors (complementary user entity controls). Once the plan auditor has obtained the proper type 2 reports, the plan auditor can complete the following sections.

Documentation of the Evaluation of Payroll Reports

In the following section, the reviewer or plan auditor can begin to evaluate whether the report contains controls and control objectives relevant to the assertions included in the employee benefit plans financial statements. (These are documented in columns #1 and #2 in the table below). In addition, the plan auditor will need to evaluate whether the tests of controls performed by the service auditor and the results of those tests provide sufficient appropriate evidence of the operating effectiveness of the controls to support the auditor's risk assessment. The auditor should consider the following factors in making that evaluation:

a. The nature, timing, and extent of the testing. For example, when testing controls, the service auditor should perform procedures in addition to inquiry, as required by related risk assessment standards; and

b. Results of the tests of controls (e.g., any noted deviations?).

Evaluation of the Control Objectives Continued

Page # in the service organization's description or service auditor's description of tests of controls where control objective is listed (from Section VI)	Control objective as listed in the description (from Section VI)	Does the description of the controls and the control objectives enable the plan auditor to evaluate the design and confirm the implementation of relevant controls and assess risk? (Yes/No)	Do the tests of operating effectiveness and results of those tests support the achievement of the stated control objective? (Yes/No) Note: Consider the effect of any deviations identified in the table above in Section VI	Reference from Section VII to complementary user entity controls identified in the description that are in place to support the plan auditor's risk assessment.
Controls/Control Objectives Related to Set-up of New Employees (demographic data, pay rates, withholding amounts)				
Controls/Control Objectives Related to Computation of Payroll Amounts Based on Rates (Salary, Hourly)				
Controls/Control Objectives Related to Computation of withholdings (401(k), H&W, etc.)				
Controls/Control Objectives Related to Reporting of Payroll Amounts Paid and Remitted				
Controls/Control Objectives Related to Termination of employees and removal from payroll records				

Section X – Conclusion

Has the user auditor obtained a sufficient understanding of the control objectives and related controls at the service organization that is relevant to the plan's internal control over financial reporting in order to assess the risks of material misstatements and to design the nature, timing and extent of further audit procedures?

_____ Yes

_____ No

Note: If the plan auditor concludes that information is not available to obtain a sufficient understanding to assess the risks of material misstatement, he or she may consider contacting the service organization to obtain specific information or request that a service auditor be engaged to perform procedures that will provide the necessary information, or the plan auditor may visit the service organization and perform such procedures.

Include any additional comments.

Prepared by: _____ Date: _____

Reviewed by: _____ Date: _____

Defined Contribution 401(k) Plans

Defined Contribution 401(k) Plans

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Understand the components of the financial statements;
- Identify the differences between ERISA and ERISA Section 103(a)(3)(C) audit procedures; and
- Understand the types of investments that may be offered in a 401(k) plan.

I. Financial statements

A. SECURE Act 2.0

1. SECURE 2.0 Act

On December 29, 2022, President Biden signed into law the Consolidated Appropriations Act of 2023, which includes the package of retirement provisions referred to as "SECURE 2.0." These provisions continue the themes and reforms that began with the 2019 SECURE Act, focusing on getting more participants into the retirement system, finding ways for them to accumulate more assets, and then ensuring they get connected with those assets when retirement comes.

2. Key provisions of SECURE 2.0 for plan sponsors

Required changes for sponsors effective for plan years beginning on or after January 1, 2024 (unless otherwise noted):

a. **A further increase in the required minimum distribution (RMD) age** – Building on the SECURE Act's increase in the RMD age to 72, SECURE 2.0 will increase the RMD age to 73 beginning in 2023 and then to 75 in 2033. (In addition, penalties for those who fail to take their RMDs would be reduced.) What does this mean? Anyone who turns 72 in 2023 is not required to take an RMD for 2023, instead they will be required to start taking RMDs for calendar year 2024, the year they turn 73.

b. **Catch-up contributions required to be Roth** – Special catch-up contributions for DC plan participants beginning at age 50 (if allowed by the plan) are now required to be made on a Roth basis for participants who earn $145,000 (with indexation after 2024) or more in the prior year. The Internal Revenue Service has released IRS Notice 2023-62, which announces a two-year administrative transition period with respect to the requirement under section 603 of the SECURE 2.0 Act that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions.

c. **Further expansion of eligibility to long-term, part-time workers** – The long-term, part-time worker eligibility provision that was first added by the SECURE Act would change so participation in a DC plan would be attained after just two consecutive years of 500 or more hours (instead of three under the SECURE Act). However, this two-year provision doesn't take effect until January 1, 2025, which means the original SECURE Act three-year provision still applies for 2024. (To clarify, this means if you have between500 and 1,000 hours in each of the years 2021, 2022 and 2023, you will become a participant under the original SECURE Act provision in 2024. After that, an employee only needs two consecutive years between 500 and 1000 hours to first obtain eligibility.)

d. **Mandatory cash out limits** – The limit for mandatory cash outs, last changed in 1997, would be raised from $5,000 to $7,000 (without any indexation in future years).

e. **Emergency withdrawal expenses** – An exception from the 10% tax would be provided for emergency expenses, which are certain unforeseeable or immediate financial needs, on a limited basis (once per year, up to $1,000). Three-year optional payback period. Participants are restricted from taking another emergency withdrawal within three years of any unpaid amount on a previous withdrawal.

f. **Required auto-enrollment for new DC plans** – Almost all new DC plans would be required to auto- enroll employees upon hire. (Existing DC plans would be exempt.) This provision would be applicable for plan years beginning on or after January 1, 2025.

g. **Annual paper benefit statement** – Plan sponsors relying on the Department of Labor (DOL)'s 2020 eDelivery regulations would be required to provide a paper benefit statement at least once annually for a defined contribution plan and at least once every three years for a defined benefit plan, unless a participant elects otherwise. This provision would be applicable for plan years beginning on or after January 1, 2026.

Optional changes for sponsors to consider (available upon enactment unless otherwise noted):

a. **Student debt retirement benefit** – Student loan payments could be treated as elective deferrals for the purposes of matching contributions to a retirement plan. This provision is available for plan years beginning on or after January 1, 2024.

b. **Emergency savings accounts** – For plan years beginning on or after January 1, 2024, employers have the option to offer emergency savings accounts within the retirement plan to non-highly compensated employees. Contributions to these savings accounts would be made post-tax (Roth), and the accounts are capped at $2,500 (or less if the employer so chooses).

c. **Additional catch-up contribution opportunities** – For participants who attain ages 60 through 63 within the taxable year, the catch-up contribution limit would be increased to the greater of $10,000 or 50 percent more than the "regular" catch-up amount. This provision is available for plan years beginning on or after January 1, 2025.

d. **Matching and non-elective contributions could be Roth** – If so inclined, employers could permit employees to elect for some or all of their matching and/or non-elective contributions to be treated as Roth contributions.

e. **Recouping overpayments** – Plan sponsors would be allowed to not recoup overpayments if retirees mistakenly received too much from their retirement plans; however, restrictions apply to plan sponsors who do.

f. **Self-certification of hardship withdrawals** – Employees can self-certify that they have had an event that constitutes a deemed hardship for purposes of taking a hardship withdrawal.

g. **Facilitates automatic portability** – A retirement plan service provider would be allowed to provide employer plans with automatic portability services. Such services involve the automatic transfer of a participant's default IRA (established in connection with a distribution from a former employer's plan) into the participant's new employer's retirement plan, unless the participant affirmatively elects otherwise. Effective for transactions occurring on or after twelve months after the date of enactment of SECURE 2.0.

h. **Domestic abuse withdrawals** – Certain penalty-free withdrawals in the case of domestic abuse situations would be permitted. This provision is available for plan years beginning on or after January 1, 2024.

Other provisions of note:

a. **Establishment of a "lost and found" database** – A new federal online "lost and found" database for retirement accounts would be created and maintained by the DOL to help participants find lost retirement benefits. Database would be established within two years of the enactment of the Act.

b. **Expansion of self-correction of plan violations** – Effective as of the date of enactment, all inadvertent plan violations can be self-corrected under the Internal Revenue Service's (IRS) Employee Plans Compliance Resolution System ("EPCRS") without a submission to the IRS.

c. **Qualified longevity annuity contract (QLAC) reforms** – For sponsors offering QLACs within their defined contribution plans, the requirement that the premiums for such contracts be limited to 25 percent would be eliminated, and the dollar limitation on premiums would be lifted from $125,000 to $200,000 (with indexation in future years). Effective as of the date of enactment, although the IRS is required to issue updated regulations concerning this provision within 18 months of passage.

II. Recently issued standards and other updates

A. SAS 145

In October 2021, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

SAS No. 145 supersedes SAS No. 122, as amended, Section 315 of the same title, and amends various AU-C sections in AICPA *Professional Standards*.

Deficiencies in the auditor's risk assessment procedures are a common issue identified by practice monitoring programs in the United States and worldwide. In 2020 U.S. peer reviews, the currently effective AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, was the leading source of *matters for further consideration*.

SAS No. 145, for example, enhances the following:

a. Requirements and guidance related to obtaining an understanding of the entity's system of internal control and assessing control risk; and

b. Guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

SAS No. 145 also includes revised and new requirements and guidance, including the following:

a. A revised definition of significant risk;

b. Revised requirements to evaluate the design of certain controls within the control activities component, including general information technology (IT) controls, and to determine whether such controls have been implemented;

c. A new requirement to separately assess inherent risk and control risk;

d. A new requirement to assess control risk at the maximum level such that, if the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement is the same as the assessment of inherent risk;
e. A new "stand-back" requirement intended to drive an evaluation of the completeness of the auditor's identification of significant classes of transactions, account balances, and disclosures;
f. Revised requirements relating to audit documentation;
g. New guidance on scalability; and
h. New guidance on maintaining professional skepticism.

SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

1. Fundamental aspects of SAS No. 145

SAS No. 145 builds on the foundational concepts relating to an audit of financial statements in AUC section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of *inherent risk* and *control risk*). SAS No. 145 is principles-based and audit methodology-neutral. The degree to which SAS No. 145 might affect an audit methodology may vary based on the particular audit approach and related audit methods, tools, or techniques.

2. Scalability of SAS No. 145 (enhanced and new guidance)

Complexity of an entity's activities and its environment, including its system of internal control, is the primary driver of scalability in the application of SAS No. 145. SAS No. 145 has removed the "Considerations Specific to Smaller Entities" sections previously included in the application material but has incorporated most of that content elsewhere in the standard, as appropriate, together with further revisions to promote scalability. SAS No. 145 recognizes that, although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex.

In addition, SAS No. 145 recognizes that some aspects of the entity's system of internal control may be less formalized but still present and functioning, considering the nature and complexity of the entity. When the entity's systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents).

3. Maintaining professional skepticism (enhanced and new guidance)

SAS No. 145 contains several key provisions that are designed to enhance and emphasize the auditor's professional skepticism, including the following:

a. Clarifying that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to maintain professional skepticism throughout the audit;
b. Highlighting the benefits of maintaining professional skepticism during the required engagement team discussion; and

c. Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.

4. Modernization for an evolving business environment (new guidance)

SAS No. 145 includes additional guidance that addresses significant changes in, and the evolution and increasingly complex nature of the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate. It also recognizes the ability to use automated tools and techniques (including audit data analytics) when performing risk assessment procedures.

5. Obtaining an understanding of the entity and its environment, and the applicable financial reporting framework (new requirements)

SAS No. 145 elevates the importance of understanding the applicable financial reporting framework by restructuring the previous requirements. In addition, SAS No. 145 includes the following:

a. A new explicit requirement to understand the use of IT in the entity's structure, ownership and governance, and business model. SAS No. 145 defines the IT environment, which includes IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.
b. A new requirement to obtain an understanding of how inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so in the preparation of the financial statements in accordance with the applicable financial reporting framework (the concept of inherent risk factors is described further in the text that follows).

6. Obtaining an understanding of the entity's system of internal control (new requirements and enhanced guidance)

Understanding certain aspects of the entity's system of internal control is integral to the auditor's identification and assessment of the risks of material misstatement, regardless of the auditor's planned controls reliance strategy. SAS No. 145 clarifies that the overall understanding of the entity's system of internal control is achieved through understanding (and evaluating certain aspects of) each of the following components of the system of internal control (and performing the related requirements to obtain such an understanding):

a. The control environment;
b. The entity's risk assessment process;
c. The entity's process to monitor the system of internal control;
d. The information system and communication; and
e. Control activities.

Each component comprises a collection of controls, which may be direct or indirect. Although differing requirements exist with respect to each component, SAS No. 145 clarifies the auditor's responsibilities, including the requirements to evaluate the design of certain controls within the control activities component and determine whether such controls have been implemented.

The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain the required understanding are 1) matters of the auditor's professional judgment, and 2) based on the auditor's determination of the procedures that will provide sufficient appropriate audit evidence to serve as a basis for the identification and assessment of the risks of material misstatement.

7. Terms used to describe aspects of the entity's system of internal control

SAS No. 145 applies certain revised terms consistently. These changes, made throughout GAAS, include the following:

a. The term *internal control* has been changed to *system of internal control*, and the definition has been updated to reflect that it comprises five interrelated components.
b. The use of the term *controls* has been clarified by including the following definition in the standard:
   (i) "Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context:
      - Policies are statements of what should or should not be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
      - Procedures are actions to implement policies."

8. Understanding the components of the entity's system of internal control

When identifying controls that address the risks of material misstatement, SAS No. 145 clarifies the requirement to evaluate the design and determine the implementation of certain controls within the control activities component. These controls include the following:

a. Controls over journal entries and other adjustments as required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*;
b. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and
c. Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

As described further in the text that follows, SAS No. 145 also requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

The controls for which the auditor is required to evaluate design and determine implementation are referred to as *identified controls* in SAS No. 145. Such controls might also be referred to as *relevant controls* or *key controls* in some audit methodologies.

9. Risks arising from the use of IT and general IT controls

SAS No. 145 now defines the terms *risks arising from the use of IT* and *general IT controls*. SAS No. 145 requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. To identify the risks arising from the use of IT, the auditor identifies the IT applications and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risks of material misstatement at the assertion level, as described in the preceding table under "control activities." Appendix E, "Considerations for Understanding IT" of SAS No. 145 includes guidance that may be relevant in identifying IT applications and other aspects of the IT environment that may be subject to risks arising from the use of IT.

10. Identifying and assessing the risks of material misstatement (new requirements and enhanced guidance)

The auditor's risk identification and assessment process is iterative and dynamic. In obtaining the understanding required by SAS No. 145, initial expectations of risks may be developed and may be further refined as the auditor progresses through the risk identification and assessment process.

To assist auditors in understanding the requirements related to the identification and assessment of the risks of material misstatement, SAS No. 145 clarifies various requirements and introduces new concepts and definitions.

11. Inherent risk factors

Inherent risk factors are characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be quantitative or qualitative and include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is referred to as the *spectrum of inherent risk*. The spectrum of inherent risk provides a frame of reference in determining the significance of the combination of the likelihood and magnitude of a misstatement.

Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion's susceptibility to misstatement, which, in turn, facilitates a more focused identification of risks of material misstatement at the assertion level. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement assists the auditor in assessing inherent risk, which also informs the auditor's design of further audit procedures in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. It is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk.

12. Relevant assertions (revised)

The definition of a relevant assertion was revised to clarify that an assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement, taking into account the likelihood and magnitude of a misstatement. A risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).

SAS No. 145 also clarifies that there is a reasonable possibility when the likelihood of a material misstatement occurring is more than remote. This guidance is consistent with that provided in other AU-C sections (for example, AU-C section 265).

The determination of whether an assertion is a relevant assertion continues to be made before consideration of any related controls (that is, the determination is based on inherent risk).

13. Significant class of transactions, account balance, or disclosure (new)

Although the term significant class of transactions, account balance, or disclosure is used within GAAS, particularly within AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, it was not defined. A class of transactions, account balance, or disclosure is considered significant when it has an identified risk of material misstatement at the assertion level (that is, there is one or more relevant assertions as defined in the previous section of this table). The determination of whether a class of transactions, account balance, or disclosure is significant is made before consideration of any related controls (that is, the determination is based on inherent risk).

The definition and guidance in SAS No. 145 are consistent with how the term was interpreted by various auditors when applying AU-C section 940. The introduction of the concept of a significant class of transactions, account balance, or disclosure is intended to clarify the scope of the auditor's understanding of the entity's information-processing activities as well as the auditor's responsibilities related to the identification and assessment of (and responses to) risks of material misstatement.

14. Assessing inherent risk and control risk separately

For risks of material misstatement at the assertion level, SAS No. 145 now requires separate assessments of inherent risk and control risk, which is consistent with SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. SAS No. 145, however, does not prescribe a specific method for making such risk assessments, and it does not require a combined assessment of inherent risk and control risk. The auditor's separate assessments of inherent risk and control risk may be performed in different ways, depending on preferred audit techniques or methodologies, and may be expressed in different ways.

15. Assessing control risk at the maximum level

If the auditor does not plan to test the operating effectiveness of controls, SAS No. 145 now requires the auditor to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. In other words, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level. When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of controls may still assist in the design of substantive procedures. When identified controls are designed effectively and implemented, risk assessment procedures may influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection, rather than external confirmation, or to perform procedures at an interim date, rather than at period end).

16. Significant risks

To promote a more consistent approach to determining significant risks, SAS No. 145 revised the definition of *significant risks* to focus not on the response (that is, whether a risk requires special audit consideration), as was the case with the previous definition, but on the inherent risk assessment. Accordingly, the definition in SAS No. 145 focuses on those risks for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur.

Significant risks also include those that are to be treated as significant risks in accordance with the requirements of other AU-C sections (that is, AU-C section 240 and AU-C section 550, *Related Parties*). SAS No. 145 no longer requires the auditor to determine whether a financial statement level risk is a significant risk. However, identified risks of material misstatement at the financial statement level may affect the auditor's assessment of significant risks at the assertion level.

SAS No. 145 acknowledges that the determination of whether a risk is a significant risk requires the exercise of professional judgment. AU-C section 330 continues to include special audit considerations in the form of specific requirements related to significant risks because of the nature of the risk and the likelihood and potential magnitude of misstatement related to the risk.

17. Classes of transactions, account balances, and disclosures that are not significant but are material (new and revised requirements)

SAS No. 145 includes a new "stand-back" requirement intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. For material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures (that is, there are no relevant assertions identified), SAS No. 145 requires the auditor to evaluate whether the auditor's determination remains appropriate. Materiality is in the context of the financial statements. Accordingly, classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements.

The stand-back requirement differs from the requirement in paragraph .18 of AU-C section 330, which was revised to align with the definitions in SAS No. 145 and with PCAOB AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*. Paragraph .18 of AU-C section 330 now requires the auditor to perform substantive procedures for each relevant assertion of each *significant* class of transactions, account balance, and disclosure, regardless of the assessed level of control risk (rather than for all relevant assertions related to each *material* class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required) [emphasis added].

B. SAS 149

In March 2023, the AICPA's Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 149, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*. SAS No. 149 supersedes AU-C Section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* of SAS No. 122, as amended, and makes conforming amendments to various other auditing standards.

The SAS is intended to strengthen the auditor's approach to planning and performing a group audit and to improve the quality of group audits, and to converge with the IAASB's International Standard on Auditing

(ISA) 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* (ISA 600 [Revised]).

SAS No. 149 includes, among other things, the following:

a. Provides a risk-based approach to planning and performing a group audit;
b. Introduces the term *referred-to auditor* and revises the definition of the term *component auditor*;
c. Addresses special considerations that apply to a group audit, including in circumstances in which component auditors are involved or when the group auditor makes reference to the audit of a referred-to auditor; and
d. Aligns AU-C Section 600 with other recently issued SASs and clarifies the interaction between the SAS and other AU-C Sections.

Concurrent with the issuance of SAS No. 149, the ASB also issued Statement on Quality Management Standards (SQMS) No. 3, *Amendments to QM Sections 10,* A Firm's System of Quality Management, *and 20,* Engagement Quality Reviews. The amendments to QM Sections 10 and 20 conform certain terms to language used in SAS No. 149 and provide guidance on differentiating between a resource (internal or external to the firm) and an information source.

SAS No. 149 is effective for audits of group financial statements for periods ending on or after December 15, 2026. SQMS No. 3 is effective concurrently with the effective dates provided in QM Sections 10 and 20.

Note:

It is important for auditors to understand that the provisions of SAS 149 do not specifically scope out employee benefit plans. However, in most cases, the provisions of SAS 149 will not be applicable to employee benefit plans except in very limited circumstances.

C. Other Updates

New FinREC recommendations include:

a. Presentation of amounts received in connection with revenue sharing arrangement;
b. Illustrative tax status note disclosures; and
c. ERISA Section 103(a)(3)(C) audit note disclosures.

Revenue sharing:

a. Revenue sharing amounts not considered ASC 606 revenue:
   (i) Intended to reduce administrative costs.
   (ii) Not paid for delivering or producing goods rendering services or undertaking other activities for investment manager.
b. Consider all relevant facts and circumstances, including terms of agreement, to determine appropriate presentation.
c. FinREC believes:
   (i) Presentation in plan financial statements should be applied on a consistent basis; and
   (ii) Plan should consider whether the presentation of revenue sharing amounts is a significant accounting policy that should be disclosed in the notes to the financial statements.

Illustrative tax status:

a. Tax exempt status of 403(b) plan is different from 401(k) plan:
   (i) Relates to exclusion from income of participant rather than exemption of tax for the plan.
b. Includes illustrative 403(b) plan disclosures for:
   (i) Individually designed plan that:
      - Has not obtained an individual determination letter.
      - Has obtained an individual determination letter.
c. Plan that has adopted pre-approved plan document.
d. Revises illustrative disclosures for:
   (i) ESOPs;
   (ii) DB pension plans; and
   (iii) Multiemployer plans.

ERISA Section 103(a)(3)(c)

a. FinREC believes financial statement notes should include:
   (i) A statement that certain information in the accompanying financial statements and ERISA-required supplemental schedule(s) related to investments (and notes receivable from participants, when applicable) held as of [include date of the financial statements under audit and covered by the certification], and net appreciation (or depreciation) in fair value of investments, interest and dividends, (and interest income on notes receivable from participants, when applicable) for the year ended [include date of the financial statements under audit and covered by the certification] was obtained by management and agreed to or derived from information certified as complete and accurate by a qualified institution. The name of the qualified institution that certified the information.

1. CECL update

FASB ASC 326-20-15-3 states that the requirement in FASB ASC 326, *Financial Instruments – Credit Losses*, to record an allowance for credit losses on financial instruments measured at amortized cost, does not apply to financial assets measured at fair value through net income. Accordingly, investments at fair value held by a DC and DB plan may be considered a financial asset measured at fair value through net income (such as net appreciation (depreciation)) and therefore, may not be subject to the accounting and reporting requirements of FASB ASC 326.

FASB ASC 326-20-15-3 states that the requirement in FASB ASC 326 to record an allowance for credit losses on financial assets measured at amortized cost, does not apply to loans made to participants by defined contribution employee benefit plans.

FASB ASC 326-20-35-1 requires an entity, at each reporting date, to record an allowance for credit losses on financial assets. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. Per “Pending Content” in FASB ASC 326-20-15-1, a financing receivable is considered a financial asset and is defined as a financing arrangement that has both of the following characteristics: (*a*) it represents a contractual right to receive money on demand or on fixed or determinable dates; or (*b*) it is recognized as an asset in the entity’s statement of financial position (statement of net assets available for benefits for a DC plan).

FASB ASC 326-20-35-1 states that the requirement in FASB ASC 326, *Financial Instruments — Credit Losses*, to record an allowance for credit losses on financial instruments measured at amortized cost, does not apply to financial assets measured at fair value through net income. Accordingly, investments at fair value held by an ESOP may be considered a financial asset measured at fair value through net income (such as net appreciation (depreciation)) and therefore, may not be subject to the accounting and reporting requirements of FASB ASC 326.

Accounting Standards Update (ASU) No. 2016-13, Topic 326, *Financial Instruments – Credit Losses*:

- a. Specific exclusion for participant notes receivable.
- b. Exclusions of contributions receivable in a DC plan and other receivables?
    - (i) Currently there are no other specific exclusions.
    - (ii) Topic to be addressed with the FASB.

D. DOL update

Per the DOL – Based on the 2023 Form 5500 database:

- a. 77,004 plan audits;
- b. 2,933 CPA firms performing audits;
- c. $11.4 trillion in plan assets subject to audit; and
- d. 167 million participants.

EBP Practice Size	Firms	Number of Audits
750+	16	22,713
100–749	106	24,536
25–99	352	16,020
6–24	875	10,072
3–5	627	2,378
1–2	957	1,285

1. DOL VFCP Self-Correction Program

DOL is adding a self-correction component to its Voluntary Fiduciary Correction Program (VFCP):

- a. Expands types of transactions covered under VFCP and simplifies the administrative tasks necessary to receive relief
- b. Employers and plan officials can use the self-correction component (SCC) to voluntarily self-correct delinquent participant contributions and loan repayments to pension plans of any size if lost earnings total $1,000 or less. They must also:
    - (i) Compute lost earnings on the delinquent payments using the online calculator;
    - (ii) Remit delinquent payments to the plan within 180 calendar days;
    - (iii) Pay any penalties, late fees, and other charges themselves; and
    - (iv) Ensure neither the self-corrector nor the plan is “under investigation,” as defined by the VFCP.
- c. Self-correctors must:
    - (i) Notify EBSA of the self-correction by submitting the SCC Notice with the required information through EBSA’s web tool; and
    - (ii) Collect records related to the correction, including the SCC Retention Record Checklist and a penalty of perjury statement, and provide them to the plan administrator for recordkeeping.

d. Unlike the VFCP application process, self-correctors will receive an email acknowledgment instead of a “no action” letter.

e. Self-correction of eligible inadvertent participant loan failures:

   (i) The SCC Retention Record Checklist is not required for correction of this transaction.

f. Other improvements in 2025 VFCP Update.

E. Statement of net assets available for benefits

The statement of net assets available for benefits is equivalent to the balance sheet for other financial statement audits. The statement is required to be presented in a specific format in accordance with ERISA. A comparative statement must be presented regardless of whether or not it is the first time an audit is required, which means that the prior year must still be compiled, reviewed, or audited. However, if it is the first year that the plan has been in existence, then a single year presentation is acceptable. The statement includes assets, liabilities, and the net assets that are available for future benefits to plan participants.

Following is an example of the prescribed format.

Assets:		
Investments at fair value	$XXXX	$XXXX
Investments at contract value	XXXX	XXXX
	XXXX	XXXX
Receivables:		
Employee contributions	XXXX	XXXX
Employer contributions	XXXX	XXXX
Participant notes receivable	XXXX	XXXX
Total receivables	XXXX	XXXX
Total assets	XXXX	XXXX
Liabilities:		
Excess contributions refundable	XXXX	XXXX
Net assets available for benefits	$XXXX	$XXXX

Please note that the financial statements present assets less liabilities to determine the total net assets available for future benefits. The balance of the total net assets available represents the amounts due to participants in the future whether due to retirement, death, or termination in accordance with the plan document. In a way, the net asset number is a “payable” to the participants, but an actual liability for benefits payable will never be recorded on the audited financial statements. The Form 5500 may record a benefits payable amount if the form is prepared on the accrual basis, and a reconciliation footnote would then be required to reconcile the difference in net assets per the audited financial statements and the Form 5500.

1. Assets

The statement of net assets available for benefits begins with assets and includes:

a. Investments at fair value;

b. Employee and employer receivables;

c. Participant notes receivable;

d. Other accrued receivables such as accrued investment income; and

e. Cash balances.

Nonparticipant-directed investments must be shown by general type either on the face or in the notes and indicate whether or not the fair value was measured by quoted market prices or determined otherwise.

Most 401(k) plans offer a variety of investment choices. Some of the most common examples of investment options include:

a. Common collective trust funds;
b. Pooled separate accounts;
c. Units of participation in a master trust;
d. Mutual funds;
e. Bonds;
f. Preferred stock, etc.

Defined contribution plans should have an investment policy statement that has been approved by the audit or benefits committee for the plan. The investment policy statement should take into consideration the investment objectives, time horizons, and risk tolerances of the participants. The investment policy statement is intended to assist the plan's fiduciaries by ensuring that they make investment-related decisions in a prudent manner. It outlines the underlying philosophies and processes for the selection, monitoring, and evaluation of the investment options and investment managers utilized by the plan.

Specifically, the investment policy statement:

a. Defines the plan's investment objectives.
b. Defines the roles of those responsible for the plan's investments.
c. Describes the criteria and procedures for selecting investment options and investment managers.
d. Establishes investment procedures, measurement standards, and monitoring procedures.
e. Describes ways to address investment options and investment managers that fail to satisfy established objectives.
f. Provides appropriate diversification within investment vehicles.

If the plan does not have an investment policy statement, then the plan auditor should consider reporting a significant deficiency in the plan's internal control. Investment policy statements are utilized by plan sponsors to meet their fiduciary duty for monitoring the investments and setting parameters or benchmarks that must be maintained by the investment.

The most common investment options offered by 401(k) plans and available to participants include the investment options noted above and are described in more detail below. These same investment options are typically available to ESOP plans, defined benefit plans, and health and welfare plans, as well.

a. **Common collective trust funds:**
    (i) Offered by financial institutions or trust companies.
    (ii) Plans acquire units of participation that represent an undivided interest in the underlying assets of the trust.
    (iii) Receive monies from multiple employers or groups of corporation under common control.
    (iv) Earnings are reinvested back into the fund and invested in the specific objective of the fund.
    (v) Allows individual plans to combine their purchasing power and engage in financial transactions that would not be feasible otherwise.

(vi) Trust does not have a ticker symbol, but the underlying assets in the trust may or may not be actively traded.

b. **Pooled separate accounts:**

(i) Maintained by insurance companies.

(ii) Funds are not commingled with the general assets of the insurance company but are instead placed in a separate account in which several plans participate.

(iii) The plan's share of the assets is determined on a participation-unit or variable-unit basis.

(iv) Contributions from different employers are pooled together and invested jointly.

(v) Unit value is based on the value of the underlying investments of the pooled separate account.

c. **Mutual funds:**

(i) Also known as registered investment companies.

(ii) Plans hold units of participation in the funds which represent the net asset value of the units held by the plan.

(iii) The registered investment company must be registered with the Securities and Exchange Commission, must be governed by a board of directors or board of trustees, and managed by a registered investment advisor.

(iv) Mutual funds have a net asset value (NAV) that is the dollar value of one share in the fund; this is the price that investors pay or receive when they buy or sell shares in the fund.

(v) Examples include money market funds, bond funds, stock or equity funds, and hybrid funds.

d. **Master trust and similar vehicles:**

(i) Offered by a plan sponsor or group of corporations under common control in which the assets of one or more benefit plans are combined into one trust.

(ii) Proportionate dollar interests or units of participation reflect each plan's ownership interest in the assets of the trust.

(iii) Audit requirement is at the plan and not the trust level.

e. **Self-directed accounts:**

(i) Offered as an investment option by the plan sponsor whereas the participants are allowed to purchase individual stocks, bonds, investments in real estate, limited partnerships, or other investment vehicles.

(ii) The instructions to the Form 5500 allow plan's to report participant directed brokerage accounts as a single line item instead of reporting them on the individual line items.

(iii) Auditors must determine whether or not the SDBA is covered by the certification.

(iv) Auditors will disclose how investment activity is recorded in the plan. Purchase and sales transactions are recorded on the trade date, which is the date that an agreement is entered into. The activity is recorded when the deal is entered into instead of when the funds leave or enter the account.

f. **Hard-to-value investments:**

(i) Depending on the nature of the plan, the employer and the participants, an additional investment option may be a hard to value investment such as real estate, limited partnerships, private equity funds, derivatives, etc.

(ii) A hard to value investment is anything that does not have a quoted market price on any exchange and generally does not fall under any federal or state regulations.

(iii) However, the hard to value investments may offer greater flexibility in investing strategies than registered investment companies.

g. **Guaranteed investment contracts (GIC)**:

(i) Offered by an insurance company or other entity whereas the contributions are invested in the general assets of the insurance company and provides a stated (guaranteed) rate of return and has a set maturity date. There are additional footnote disclosures for investments in guaranteed investment contracts. The necessary disclosures are as follows:

- Description of the nature of the investment contract (including how they operate) by the type of investment contract.
- Description of events that limit the ability of the plan to transact at contract value including a statement that the occurrence of each of those events that would limit the plan's ability to transact at contract value with participants in the plan is not probable.
- Description of events that would allow issuers to terminate the contract at less than contract value.
- The total contract value of each type of investment contract (for example: synthetic contracts or traditional investment contracts).

Note:

The plan sponsor and the auditor should determine whether or not the GIC is fully benefit-responsive or not. An investment contract is considered fully benefit-responsive if all of the following criteria are met, analyzed on an individual basis:

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

b. Either of the following conditions exist:

   (i) The repayment of the principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract; or

   (ii) Prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investment held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero.

   If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in the creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.

c. The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as any of the following:

   (i) Withdrawals for benefits;

   (ii) Loans; and

   (iii) Transfers to other funds within the plan.

d. An event that limited the ability of the plan to transact at contract value with the issuer and that also limits the ability of the plan to transact at contract value with the participants in the plan, such as any of the following, must be probable of not occurring:

   (i) Premature termination of contracts by the plan;

   (ii) Plant closings;

   (iii) Layoffs;

   (iv) Plan termination;

   (v) Bankruptcy;

   (vi) Mergers; and

   (vii) Early retirement incentives.

e. The plan must allow participants reasonable access to their funds.

Once the auditor has identified the types of investments offered by the plan, which is required regardless of scope, they will be able to perform audit procedures to properly test the relevant assertions. There are general audit procedures that must be applied to all investments in a full-scope audit as well as individualized procedures depending on the specific type of investments offered by the plan. If the plan auditor has been instructed by the plan administrator not to perform audit procedures with respect to the investment information certified by the trustee or custodian, then the plan auditor is not required to audit investments and investment-related information on the plan level.

Audit objectives for investments and investment-related activities in an ERISA audit (non ERISA 103(a)(3)(C)) are as follows:

a. Transactions recorded are valid.
b. Investments listed at year end exist and are owned by the plan.
c. Investments are valued properly.
d. Income transactions are properly reflected.
e. Presented fairly in financial statement and disclosures.

General auditing procedures for non-ERISA 103(a)(3)(c) audits include:

a. Obtaining an understanding of the investment strategy and its effect on the plan's investment portfolio;
b. Analyzing changes in investments during the period;
c. Determining existence and ownership of the investments usually through confirmations;
d. Reviewing minutes, agreements, and confirmations for evidence of liens, pledges, or other security in investments;
e. Testing investment transactions for proper authorization, documentation of historical cost or selling price, comparing prices with published market prices, and checking the computation of realized and unrealized gains; and
f. Testing the fair value of investments.

The trust reports contain detailed information for each investment such as purchases, sales, and realized/unrealized gains and losses. From these reports, the plan auditor should select a sample from each type of transaction.

In order to test investment transactions related to the assertions of existence, ownership, and completeness, the auditor should perform at least one of the following six procedures:

a. Physical inspection;
b. Confirmation with the issuer;
c. Confirmation with the custodian;
d. Confirmation with the counterparty;
e. Confirm unsettled transactions with broker-dealer; or
f. Reading executed partnership or similar agreements.

In order to test purchases, the auditor should agree the date of the transaction, the number of shares or units purchased, and the cost to an independent source or the original broker advice. Realized gains and losses should be tested by tracing the sales price, units sold, and gains or losses to an external source. The fair value can also be recomputed by multiplying the number of shares owned by the unit price after tracing the unit value to an external source.

The auditor should consider obtaining the audited financial statements for the various investment options as applicable in order to test the per unit valuation. Other external sources include websites such as Yahoo! Finance and Morningstar.com where the auditor can enter the ticker symbol or fund identifier, specify a specific date or range, and obtain a value that can be compared to the trust report.

As noted previously, the auditor should select samples from the detail trust reports for purchases, sales, realized and unrealized gains/losses. It is important to note that auditor judgment should be relied upon to determine the sample size as well as the method of selecting the sample such as judgmental, haphazard, random, or by utilizing sampling techniques involving individually significant items and the remaining population. Regardless of the method used to select the sample, sufficient documentation is required in order to allow an experienced auditor to understand the procedures performed and the conclusions reached.

Benefit plans may also offer as an investment option certain hard to value investments such as real estate, partnerships or LLCs, life insurance, and/or derivatives. Investments that do not have readily determinable fair values must disclose the method utilized to determine the value at year-end. The plan administrator should consider whether or not a specialist is required to assist in determining the value. When a plan invests in real estate holdings, the auditor should obtain the most recent appraisal for the property and take into consideration the reputation of the appraiser and changes in market conditions immediately after the appraisal through the end of fieldwork.

The various investment types discussed above are the most common types of investment options for employee benefit plans. It is important to note that participant loans are no longer considered an investment option and should NOT be included with total investments on the statement of net assets available for benefits. Instead, participant notes receivable will be reported on a separate line item with the other receivables of the plan. However, if the certification covers the notes receivable from participants, then in accordance with the instructions to the Form 5500, then the auditor is not required to apply procedures to the notes receivable from participants. It is still common practice though to test the notes receivable from participants regardless of whether or not they are covered by the certification.

The auditor should consider the following procedures to test participant loans:

a. Examining the signed loan request;
b. Comparing the outstanding balance at year-end to an amortization schedule;
c. Recalculating interest income;
d. Agreeing loan terms to provisions in the plan document; and
e. Confirming the outstanding loan and repayment terms with the participant.

2. Liabilities

The statement of net assets available for benefits also includes liabilities and accrued payables. Examples include administration fees payable and refundable excess contributions. Liabilities are subtracted from total assets to determine the total net assets available for benefits.

Note:

> Balances allocated to participants that have elected to withdraw from the plan but have not yet been paid **should not** be reflected as a liability in the plan's financial statements. These amounts should only be disclosed in the notes to the financial statements. In general, plans that are valued daily do not have any amounts attributed to participants that have requested a distribution prior to year-end but have not been paid. However, the auditor should inquire of plan management and the trustee or custodian to determine if there were any of these amounts. A liability should be recorded on the Form 5500 for the amounts requested for distribution before the end of the year but not paid until after year-end, but not on the financial statements. A reconciling item would also be included in the notes to the financial statements in order to agree the financial statements to the Form 5500.

Furthermore, if the Plan failed the required anti-discrimination tests, then a liability should be recorded for the excess contributions that need to be refunded to plan participants. The auditor should test the underlying supporting documentation or subsequent disbursements made by the plan in order to test the accrued liabilities.

F. Statement of changes in net assets available for benefits

In an employee benefit plan, the statement of changes in net assets available for benefits is the equivalent of an income statement for other financial statement reports. The statement must be prepared following the prescribed format as noted below.

Additions	
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments	$xxxxx
Interest	xxxxx
Dividends	xxxxx
Participant loan interest	xxxx
Less investment expenses	xxxxx
Net investment income	xxxxx
Contributions:	
Participants'	xxxxx
Employer	xxxxx
Rollover	xxxxx
	xxxxx
Total additions	xxxxx
Deductions	
Deductions from net assets attributed to:	
Benefits paid to participants'	xxxxx
Administration expenses	xxxxx
Total deductions	xxxxx
Net increase	xxxxx
NET ASSETS AVAILABLE FOR BENEFITS	
Beginning of year	xxxxx
End of year	xxxxx

The presentation above is in accordance with the prescribed format noted in the Audit and Accounting Guide for Employee Benefit Plans. Please note that a single year presentation is all that is required for the statement of changes, but a comparative statement may be presented if the auditor or plan sponsor elects. The statement of changes in net assets available for benefits includes the activity that has occurred during the year. As indicated above, additions include realized gains and losses from the various investment transactions as well as interest and dividends earned during the year. Unrealized gains and losses are also included in net investment income.

1. Contributions

Amounts withheld from participants throughout the year are recorded as participant contributions while the portion paid by the employer is recorded as an employer contribution. If the plan document allows participants to roll over amounts from other qualified benefit plans, then these amounts will also be included as an addition on the statement of changes in net assets available for benefits.

Discussion question:

Is the auditor required to perform audit procedures on participant and employer contributions in a limited scope audit? Does it matter if the trustee provided a Type 2 SOC 1 Report without exceptions that covered all contributions to the Plan?

Note:

> Net investment gain/loss or net appreciation/depreciation in the fair value of investments may be presented as a single line item on the face of the statement for certain types of investments such as mutual funds, common collective trusts, pooled separate accounts, and units of participation in a master trust. However, there must be a disclosure in the footnotes that breaks down the net investment income by type.

Prior to the SECURE Act, employers generally were able to exclude part-time employees (employees who work less than 1,000 hours per year) when providing a defined contribution plan to their employees. As women are more likely than men to work part-time, these rules can be quite harmful for women in preparing for retirement. Except in the case of collectively bargained plans, the SECURE Act Section 111 bill will require employers maintaining a 401(k) plan to have a dual eligibility requirement under which an employee must complete either a one year of service requirement (with the 1,000-hour rule) or three consecutive years of service where the employee completes at least 500 hours of service. In the case of employees who are eligible solely by reason of the latter new rule, the employer may elect to exclude such employees from testing under the nondiscrimination and coverage rules, and from the application of the top-heavy rules.

SECURE 2.0 Act expands the long-term, part-time worker eligibility provision that was first added by the SECURE Act so that participation in a DC plan would be attained after just two consecutive years of 500 or more hours (instead of three under the SECURE Act). However, this two-year provision doesn't take effect until January 1, 2025, which means the original SECURE Act three-year provision still applies for 2024. (To clarify, this means if you have between500 and 1,000 hours in each of the years 2021, 2022 and 2023, you will become a participant under the original SECURE Act provision in 2024. After that, an employee only needs two consecutive years between 500 and 1000 hours to first obtain eligibility.)

2. Investment income

For non-ERISA 103(a)(3)(C) audits, the auditor should perform procedures to test the investment income and activity for the year. (Investments and investment related activity are exempt from audit procedures in a limited scope audit.) Investment income includes interest, dividends, realized gains and losses from the sale of investments, and unrealized gains and losses due to changes in value from one period to the next.

Auditing objectives for investment income are to:

a. Provide assurance that earnings from the investments of the plan have been properly recorded in all material respects;
b. Properly allocated to the individual participant account records; and
c. Ensure that unrealized and realized gains and losses are properly calculated and recorded in the financial statements in accordance with generally accepted accounting principles.

3. Distributions

Distributions are a reported as a deduction from plan assets on the statement of changes in net assets. Benefit payments, along with the nature, timing, and form, are also determined in accordance with the provisions of the plan document. Benefits accumulate in an individual participant's account and determine the amount of benefits due to the participant.

In most circumstances, a participant cannot receive a distribution from a plan until one of the following occurs:

a. Reaches age 59½;
b. Has a severance from employment;
c. Dies;
d. Becomes disabled;
e. In the case of salary reduction contributions, encounters financial hardship; or
f. Has a qualified reservist distribution.

It is important to note that regardless of when a participant receives a distribution from the plan under one of situations above, it is taxable in full as ordinary income, unless it is made from a Roth account or an account that includes other after-tax contributions.

As stated in the January 2021 AICPA Audit and Accounting Guide for Employee Benefit Plans, the relevant assertions related to benefit payments include:

a. Benefit payments have been made in accordance with plan provisions and related documents;
b. Benefit payments are made to, or on behalf of, persons entitled to them and only to such persons (that is, that benefit payments are not being made to deceased beneficiaries or persons other than eligible participants and beneficiaries);
c. Benefit payments are recorded in the proper account, amount, and period; and
d. The payments are presented and disclosed in accordance with the applicable financial reporting framework.

In accordance with the SECURE Act, there is now a new in-service withdrawal right for childbirth and adoption expenses. There was no special tax relief for plan distributions for childbirth or adoption expenses incurred within a year following birth or legal adoption. The new legislation under the SECURE Act allows defined contribution plans to allow withdrawals of up to $5,000 for eligible childcare and adoption expenses and these withdrawals will not be subject to the 10 percent early withdrawal penalty. These amounts may also be re-contributed back to the plan. Please also note that these are similar to hardship withdrawals whereas that are treated as not eligible for rollover, and not subject to mandatory 20 percent withholding (rather 10 percent withholding applies, unless electing out). These withdrawals are effective for years beginning after December 31, 2019.

The policy behind the new SECURE Act rule is to ensure that individuals spend their retirement savings during their lifetime and not use their retirement plans for estate planning purposes to transfer wealth to beneficiaries. However, the age 70½ was first applied in the retirement plan context in the early 1960s and has never been adjusted to take into account increases in life expectancy. The bill increases the required minimum distribution age from 70½ to 72.

The SECURE Act legislation modified the required minimum distribution rules with respect to defined contribution plan and IRA balances upon the death of the account owner. Under the legislation, distributions to individuals other than the surviving spouse of the employee (or IRA owner), disabled or chronically ill individuals, individuals who are not more than 10 years younger than the employee (or IRA owner), or child of the employee (or IRA owner) who has not reached the age of majority are generally required to be distributed by the end of the tenth calendar year following the year of the employee or IRA owner’s death.

4. Hardship withdrawals

Hardship withdrawals can only be made to the extent that there is a financial hardship, as defined in the plan document and in accordance with IRS rules.

Keep in mind that legislation has expanded the types of contributions a plan may allow the participant to access for a hardship distribution and lightened the documentation requirement of administrators. Access to these other contributions for hardships may provide additional relief.

5. Partial plan terminations

Auditors should be aware of one of the pitfalls affecting more plan sponsors in the past couple of years due to the economic crisis. Partial plan terminations are affecting more and more employers due to the recession. Unfortunately, due to lay-offs and facility closings, plan sponsors may be subject to the rules surrounding partial plan terminations and vesting requirements.

If a plan sponsor has experienced a downsize or reduction in workforce and the lay-off or closing effects 20 percent or more of the plan population, then all affected participants must become 100 percent vested.

Unfortunately, many employers do not realize they have an issue with a partial plan termination until after the fact. Therefore, a correction must be made in order to make the participants affected by the triggering event whole.

Under Internal Revenue Code (Code) Section 411(d)(3), a qualified retirement plan that incurs a termination or partial termination must fully vest benefits for all affected participants. Under IRS guidance, a partial termination is generally deemed to have occurred if there is at least a 20 percent reduction in participating employees due to an employer-initiated severance (e.g., layoff, furloughs, etc.) that is not considered “routine” turnover.

6. Forfeitures

The plan document will specify how forfeitures are to be treated. When a participant requests a distribution from the plan, the amount that they will actually receive will be based on their vested interest in their individual account balance. Please note that participants are always 100 percent vested in the amount that they have contributed; however, the amounts contributed by the employer to their individual account may be subject to vesting provisions.

A participant may vest according to one of several methods. The first method is a graduated vesting schedule. Participants may be subject to incremental vesting percentages based on years of service that must be satisfied in order to be eligible to receive the monies in their account balance.

For example, a graded vesting schedule may appear as follows:

Years of Employment	Vesting Percentage
0–1 year	0 percent
1–2 years	20 percent
2–3 years	40 percent
3–4 years	60 percent
4–5 years	80 percent
More than 5 years	100 percent

Another example of a vesting schedule is a cliff-vesting schedule. Under a cliff-vesting schedule, a participant is 0 percent vested in employer contributions until they have completed three years of service. Employers are prohibited from extending the vesting period beyond six years.

When a participant terminates employment prior to reaching the full vesting status and their individual account includes contributions from the employer, then the unvested portion of employer contributions must be forfeited. The plan document will specify how forfeitures are to be accounted for in the future. Forfeitures may be used to:

a. Reduce future employer contributions;
b. Pay plan expenses; and
c. Reallocate amongst the remaining participants.

Forfeitures must be identified by the plan records in order for the auditors to test the balance of unallocated forfeitures at the end of the plan year. The balance in the unallocated forfeiture account should be monitored to ensure that the balance does not continue to increase without being utilized in accordance with the plan document.

Discussion question:

Could you identify and discuss specific audit procedures and workpapers for the audit areas above?

G. Sample selections

When auditors begin the testing for the audits areas noted above, one of the first things that is performed is determining an appropriate sample size for each of the areas. Sample size is an area that often results in differences in opinion amongst auditors in regard to determining the appropriate sample size. Determining the appropriate sample size for a particular audit area can be determined in a variety of ways. The method used to determine the sample size is based on auditor judgment or internal firm policies. Auditors may elect to develop a formal policy that can be utilized for the majority of employee benefit audits, or they may elect to follow published sampling guidelines from sources such as the AICPA Audit Guide *Audit Sampling*. Regardless of the method used to determine the sample size, the auditor must ensure that the proper documentation has been obtained and documented, including:

a. Total population;
b. How the sample was selected;
c. Definition of a deviation;
d. Results of procedures; and
e. How variances were treated.

Sampling methods will typically be utilized in various audit areas in a plan due to the fact that it is not cost efficient or effective to test the entire population. Regardless of the audit area, a variety of sampling methods may be employed individually or in combination with one another.

However, there are some common factors that may influence the sampling method selected, including:

a. Nature and quality of the population;
b. Availability of information about the items in the population;
c. The need to measure accuracy;
d. Whether detailed analysis of the sample is expected; and
e. Cost and operational concerns.

Discussion question:

What is your preferred method of sampling for employee benefit plan audits?

Examples of statistical sampling include simple random sampling (SRS) and systematic sampling (SS).

1. Simple random sampling (SRS)

All items of the population are given an equal probability.

2. Systematic sampling (SS)

Systematic sampling relies on arranging the target population according to an ordering or numbering system and then selecting items at regular intervals through that ordered list.

Systematic sampling:

A simple example would be to select every 10th name from the participant allocation report and payroll records.

3. Haphazard sampling

Haphazard sampling is defined as a technique utilized by auditors that does not follow a structured order.

4. Judgmental sampling

Judgmental sampling is defined as sampling selection where the plan auditor may use their judgment in selecting items for sampling.

A best practice recommendation for plan auditors is to make the appropriate sample selections during the planning phase stage of the audit. By selecting the samples and providing these selections to the plan sponsor during this time, then the plan sponsor has adequate time between the planning and the start of fieldwork to pull all personnel records and other supporting documentation for the auditor's testing purposes. If the auditor makes the sample selections during the planning phase, then there is the potential to increase audit efficiency and reduce downtime. The auditor is able to continue with other procedures that do not involve sampling and not waste precious budget time waiting on the plan.

Audit Opinions

Audit Opinions

Learning objectives

Upon reviewing this chapter, the reader will be able to:
- Complete the appropriate auditor report for ERISA and ERISA Section 103(a)(3)(C) audits;
- Understand the modifications that may be necessary to the standard report; and
- Determine the appropriate supplemental schedule in accordance with the DOL rules and regulations.

I. Recently issued SASs that impact employee benefit plan audit reports

A. SAS 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*

When performing an audit of ERISA plan financial statements, all the AU-C sections apply, except for the following AU-C sections or portions thereof, which are not applicable to an audit of ERISA plan financial statements because those requirements and related application material are specifically covered in this SAS:

a. AU-C Section 700, *Forming an Opinion and Reporting on Financial Statements*; and

b. Paragraph .09 of AU-C Section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

Upon implementation of this SAS, there will no longer be any references to a "limited-scope" audit. Instead, management may engage an auditor to perform an "**ERISA Section 103(a)(3)(C) audit**."

a. Not considered a scope limitation; therefore, the auditor would no longer issue a modified opinion (typically a disclaimer of opinion) due to information that is certified by a qualified institution.

b. Instead, the report provides a two-pronged opinion that is based on the audit and on the procedures performed relating to the certified investment information.

1. New and unique form of auditor reporting

The auditor's report should include a statement that, in the auditor's opinion, based on the audit and the procedures performed as described in the auditor's responsibility section:

a. The amounts and disclosures in the financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with the applicable financial reporting framework; and

b. The information in the financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

2. Supplemental schedules

When management elects to have an ERISA Section 103(a)(3)(C) audit, the auditor should include an Other Matter paragraph in the ERISA Section 103(a)(3(C) audit report that contains a statement whether, in the auditor's opinion:

a. The form and content of the supplemental schedules, other than the information in the supplemental schedules that are agreed to or is derived from the certified investment information, is presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA; or
b. The information in the supplemental schedules related to assets held by and certified to by a qualified institution agreed to or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

3. ERISA Section 103(a)(3)(C) audit procedures

When management elects to have an ERISA Section 103(a)(3)(C) audit, the auditor should evaluate management's assessment of whether the entity issuing the certification is a qualified institution under DOL rules and regulations. If, as a result of management's assessment, the auditor has concerns about whether the entity preparing and certifying the investment information is a qualified institution, the auditor should discuss their concerns with management. If management does not provide sufficient information that supports its determination that the entity preparing and certifying the investment information is a qualified institution, then the auditor should discuss their concerns with those charged with governance and determine the implications for the audit.

The auditor should identify which investment information is certified. The auditor should perform the following procedures on the certified investment information:

a. Obtain from management and read the certification as it relates to investment information prepared and certified by a qualified institution;
b. Compare the certified investment information with the related information presented and disclosed in the ERISA plan financial statements and ERISA-required supplemental schedules; and
c. Read the disclosures relating to the certified investment information to assess whether they are in accordance with the presentation and disclosure requirements of the applicable financial reporting framework.

Other key provisions in this SAS include:

a. Engagement acceptance;
b. Audit risk assessment and response in an audit of an ERISA plan financial statements;
c. Plan tax status;
d. Prohibited transactions;
e. Evaluation and documentation ;
f. Communication with management or those charged with governance;
g. Written representations;
h. Forming an opinion and reporting;
i. Written management representations; and
j. Considerations related to the Form 5500.

II. The ERISA auditor standard report

The audit reports for benefit plan audits should be addressed to the plan administrator, board of trustees, participants, beneficiaries, or the plan itself. In accordance with AU Section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*), the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Prior to the issuance of the new auditing standards, the audit opinion was dated the same as the last day of fieldwork. So, auditors must ensure that they are in compliance with AU 530.

This chapter will focus on the standard audit report for an ERISA audit and an ERISA Section 103(a)(3)(C) audit.

A. ERISA audit reports (non-ERISA Section 103(a)(3)(C))

Besides the financial statements and related disclosures, which may conform to the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* ASC 962, *Plan Accounting – Defined Contribution Pension Plans*, ERISA and DOL regulations require additional information to be disclosed in the financial statements or presented in the supplemental schedules. Some of this information is required to be covered by the auditor's report; for example, supplemental schedules, but other required additional information need not be covered by the auditor's report. Because the supplemental schedules are required by ERISA and DOL regulations and they are not designated accounting standard setters, the supplemental schedules are not considered *required supplementary information* as defined in AU Section 558, *Required Supplementary Information* (AICPA, *Professional Standards*), and therefore, AU Section 558 does not apply.

AU Section 551, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), addresses the auditor's responsibilities when the auditor is engaged to report on whether the supplemental schedules are fairly stated, in all material respects, in relation to the financial statements as a whole.

ERISA requires that certain supplemental schedules accompany the ERISA plan financial statements (referred to as ERISA-required supplemental schedules), if applicable. In addition, ERISA plan financial statements may have accompanying supplementary information that is not required by ERISA. When auditing ERISA plan financial statements, the auditor should report on whether the ERISA-required supplemental schedules are fairly stated, in all material respects, in relation to the financial statements as a whole, in accordance with AU-C Section 725. AU-C Section 725 addresses the performance requirements as well as the form and content of the report on supplementary information in relation to the financial statements as a whole. AU-C Section 725 requires the auditor to report on the supplementary information in either: (a) an Other Matter paragraph in accordance with AU-C Section 706; or (b) in a separate report on the supplementary information.

When the auditor is also engaged to report on supplementary information accompanying the ERISA plan financial statements that is not required by ERISA and that is not required by the applicable financial reporting framework, AU-C Section 725 applies.

1. ERISA-required supplemental schedules

When reporting on the ERISA-required supplemental schedules in accordance with AU-C Section 725, the reporting elements discussed in paragraph .09 of AU-C Section 725 should be replaced with the following:

a. A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole;
b. The title of the supplemental schedules and the periods covered;
c. A statement that the supplemental schedules are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA;
d. A statement that such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements;
e. A statement that the information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America;
f. A statement that in forming the auditor's opinion on the supplemental schedules, the auditor evaluated whether the supplemental schedules, including their form and content, are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA;
g. When the auditor's report on the audited ERISA plan financial statements contains an unmodified opinion and the auditor has concluded that the ERISA-required supplemental schedules are fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the information in the accompanying schedules is fairly stated, in all material respects, in relation to the financial statements as a whole, and the form and content are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA; and
h. When the auditor's report on the audited ERISA plan financial statements contains a qualified opinion and the qualification has an effect on the ERISA-required supplemental schedules, a statement that, in the auditor's opinion, except for the effects or possible effects on the supplemental schedules of (refer to the paragraph in the auditor's report explaining the qualification), the information in the accompanying supplemental schedules is fairly stated, in all material respects, in relation to the financial statements as a whole, and the form and content are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.

When the auditor's report on the audited ERISA plan financial statements contains an adverse opinion or a disclaimer of opinion, the auditor is precluded from expressing an opinion on the ERISA-required supplemental schedules. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the ERISA-required supplemental schedules. If the auditor does not withdraw, the reporting elements in paragraph .11 of AU-C Section 725 should be replaced with the following:

a. If the auditor's report on the audited ERISA plan financial statements contains an adverse opinion, a statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole, or if the auditor's report contains a disclaimer of opinion, a statement that the auditor was engaged for the purpose of forming an opinion on the financial statements as a whole;
b. A statement that the supplemental schedules are presented for the purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA; and
c. A statement that because of the significance of the matter described in the auditor's report (refer to the Basis for Adverse Opinion or Basis for Disclaimer of Opinion sections, as applicable), it is inappropriate to, and the auditor does not, express an opinion on the supplemental schedules.

Illustration 1: An auditor's report on financial statements for a defined contribution retirement plan subject to ERISA

Circumstances include the following:

a. The auditor performed a non-ERISA Section 103(a)(3)(C) audit as of and for the years ended December 31, 2023, and 2022, in accordance with GAAS.
b. The auditor has concluded that an unmodified ("clean") opinion on the ERISA plan financial statements is appropriate based on the audit evidence obtained.
c. In accordance with paragraph .86 of AU-C Section 703, when the auditor expresses an opinion on all periods presented, a continuing auditor should update the report on the financial statements of one or more prior periods presented on a comparative basis with those of the current period. When issuing an updated report, the information considered by the continuing auditor is that which the auditor becomes aware of during the audit of the current period financial statements. An updated report is issued in conjunction with the auditor's report on the current period financial statements. In this situation, because the auditor performed a full-scope audit in the prior year and is performing a non-Section 103(a)(3)(C) audit in the current year, the auditor would have obtained sufficient appropriate audit evidence in each year in which to conclude whether the financial statements are fairly presented, in all material respects. Accordingly, the auditor has concluded that the standard form of report is appropriate provided the auditor has updated the prior year report as discussed previously.
d. The report on the 2023 ERISA-required supplemental schedules is presented in a separate section in accordance with paragraphs .129-.130 of AU-C Section 703. The auditor has concluded that the information in the 2021 ERISA-required supplemental schedules is fairly stated, in all material respects, in relation to the financial statements as a whole, and the form and content are presented in conformity with the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA.

When a continuing auditor performed a full-scope audit of comparative ERISA plan financial statements in the prior year and a non-Section 103(a)(3)(C) audit in the current year (the initial year of implementation of the EBP SAS, as amended), the continuing auditor updates their prior year report in accordance with paragraph .86 of AU-C Section 703. This would result in issuing one report that refers to each period for which the financial statements are presented and on which the auditor is expressing an opinion (for example, for the year ended December 31, 2023, and 2022). This would not differ from the form of report when the auditor performs a non-Section 103(a)(3)(C) audit in both years. Illustration 1 from Exhibit A of AU-C Section 703 (also shown in Chapter 11 of AICPA Audit and Accounting Guide *Employee Benefit Plans*) contains such an example.

Paragraph .86 of AU-C Section 703 states that when expressing an opinion on all periods presented, a continuing auditor should update the report on the financial statements of one or more prior periods presented on a comparative basis with those of the current period. The auditor's report on comparative financial statements should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit. Paragraph .A125 of AU-C Section 703 explains that an updated report on prior period financial statements is distinguished from a reissuance of a previous report. When issuing an updated report, the information considered by the continuing auditor is that which the auditor has become aware of during the audit of the current period financial statements. An updated report is issued in conjunction with the auditor's report on the current period financial statements.

Independent Auditor's Report[1]

[*Appropriate Addressee*]

Opinion

We have audited the financial statements of ABC 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), which comprise the statements of net assets available for benefits as of December 31, 20X3 and 20X2, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X3, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the net assets available for benefits of ABC 401(k) Plan as of December 31, 20X3 and 20X2, and the changes in its net assets available for benefits for the year ended December 31, 20X3, in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC 401(k) Plan and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

[1] AU-C Section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, Exhibit A, Illustration 1.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Management is also responsible for maintaining a current plan instrument, including all plan amendments, administering the plan, and determining that the plan's transactions that are presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants, to determine the benefits due or which may become due to such participants.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

a. Exercise professional judgment and maintain professional skepticism throughout the audit.
b. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
c. Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC 401(k) Plan's internal control. Accordingly, no such opinion is expressed.
d. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
e. Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Supplemental Schedules Required by ERISA

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplemental schedules of [*identify title of supplemental schedules and periods covered*] are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS.

In forming our opinion on the supplemental schedules, we evaluated whether the supplemental schedules, including their form and content, are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.

In our opinion, the information in the accompanying schedules is fairly stated, in all material respects, in relation to the financial statements as a whole, and the form and content are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.

[*Signature of the auditor's firm*]
[*City and state where the auditor's report is issued*]
[*Date of the auditor's report*]

2. Applicable financial reporting framework

DOL regulations permit, but do not require, financial statements included in the annual report (Form 5500) to be prepared on a basis of accounting other than U.S. GAAP (for example, a special purpose framework such as a modified cash basis of accounting). In such cases, the regulations do not prohibit variances from U.S. GAAP if the variances are described in a note to the financial statements.

A common example of the use of a basis other than U.S. GAAP is financial statements prepared on the modified cash basis of accounting for filing with the DOL. AU-C Section 800 addresses special considerations in the application of AU-C Sections 200-700 to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, a tax, a regulatory, a contractual, or an other basis of accounting. A cash basis of accounting is defined as a basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support. For an employee benefit plan, cash basis financial statements that adjust investments to fair value are typically considered to be prepared on a modified cash basis of accounting.

3. Modifications to the opinion

AU-C Section 705 addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with this SAS, the auditor concludes that a modification to the auditor's opinion on the ERISA plan financial statements is necessary. In the case of an ERISA Section 103(a)(3)(C) audit, the auditor should apply the requirements in AU-C Section 705, adapted as necessary in the circumstances of the engagement, including the following:

a. When the auditor expresses a qualified opinion due to a material misstatement of the financial statements, the auditor should amend the Opinion section to state that, in the auditor's opinion, except for the effects of the matters described in the Basis for Qualified Opinion section, based on the audit and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:
   (i) The amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
   (ii) The information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C). (Ref: par. A140.)

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase "except for the possible effects of the matter(s)…" for the modified opinion.

a. **When the auditor expresses an adverse opinion, the requirements in paragraph 105 do not apply**, and the auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matters described in the Basis for Adverse Opinion section, the financial statements are not presented fairly in accordance with the applicable financial reporting framework.
b. When the auditor expresses a qualified or an adverse opinion, the auditor should amend the description in the Basis for Opinion section to state whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified ERISA Section 103(a)(3)(C) audit opinion.
c. When the auditor disclaims an opinion, the auditor should amend the statement required by paragraph 103b, which indicates that the auditor performed an audit of the financial statements, to state that the auditor was engaged to perform an audit of the financial statements. The auditor should also amend the description of the auditor's responsibility for the audit of the financial statements and the description of the scope of the audit to state only the following: "Our responsibility is to conduct an audit of the plan's financial statements in accordance with auditing standards generally accepted in the United States of America and to issue an auditor's report. However, because of the matters described in the Basis for Disclaimer of Opinion section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements."
d. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the requirements in paragraph 105 do not apply, and the auditor should state in the Disclaimer of Opinion section that:
   (i) Because of the significance of the matters described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and
   (ii) Accordingly, the auditor does not express an opinion on the financial statements.

B. ERISA Section 103(a)(3)(C) audit reports

The Employee Retirement Income Security Act of 1974 (ERISA), Section 103(a)(3)(C), allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. The election is available however, only if the trustee, custodian, or insurance company certifies both the accuracy and completeness of the information submitted. Certifications that address only accuracy or completeness, but not both, do not comply with the Department of Labor's (DOL) regulation. The certification does not apply to information about investments held by a broker or dealer or an investment company. In addition, if an ERISA Section 103(a)(3)(C) audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, then separate individual plan certifications from the trustee or the custodian need to be obtained by the plan administrator for the allocation of the assets and the related income activity to the specific plan. The exemption applies only to investment information certified by the qualified trustee, custodian, or insurance company and does not extend to participant data, contributions, benefit payments, or other information whether or not it is certified by the trustee or custodian.

Illustration 2: ERISA Section 103(a)(3)(C) audit report in the year of implementation

Circumstances include the following:

a. Management elected an ERISA Section 103(a)(3)(C) audit for the 2023 plan year financial statements as permitted by Code of Federal Regulations (CFR), Labor, Title 29, Section 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.
b. The auditor performed an ERISA Section 103(a)(3)(C) audit as of and for the years ended December 31, 2023, and 2022, in accordance with GAAS.
c. The auditor has concluded that the ERISA Section 103(a)(3)(C) report is appropriate as of and for the years ended December 31, 2023, and 2022, based on the audit evidence obtained.
d. The report on the 2023 ERISA-required supplemental schedules is presented as an Other Matter paragraph in accordance with paragraph .132 of AU-C Section 703. The auditor has concluded that the form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, is presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA. The information in the supplemental schedules related to assets held by and certified to by a qualified institution agreed to or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

Independent Auditor's Report[2]

[*Appropriate Addressee*]

Scope and Nature of the ERISA Section 103(a)(3)(C) Audit for the Financial Statements

We have performed an audit of the financial statements of ABC 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), as permitted by ERISA Section 103(a)(3)(C) (ERISA Section 103(a)(3)(C) audit). The financial statements comprise the statements of net assets available for benefits as of December 31, 2023, and 2022, and the related statement of changes in net assets available for benefits for the year then ended, and the related notes to the financial statements.

Management, having determined it is permissible in the circumstances, has elected to have the audit of the financial statements performed in accordance with ERISA Section 103(a)(3)(C) pursuant to 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA. As permitted by ERISA Section 103(a)(3)(C), our audits need not extend to any statements or information related to assets held for investment of the plan (investment information) by a bank or similar institution or insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency, provided that the statements or information regarding assets so held are prepared and certified to by the bank or similar institution or insurance carrier in accordance with 29 CFR 2520.103-5 of the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA (qualified institution).

Management has obtained a certification from a qualified institution as of and for the years ended December 31, 2023, and 2022, stating that the certified investment information, as described in Note X to the financial statements, is complete and accurate.

Opinion

In our opinion, based on our audit and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:

a. The amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America; and
b. The information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC 401(k) Plan and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our ERISA Section 103(a)(3)(C) audit opinion.

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2 Example uses Exhibit A of AU-C Section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA.*

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management's election of the ERISA Section 103(a)(3)(C) audit does not affect management's responsibility for the financial statements.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Management is also responsible for maintaining a current plan instrument, including all plan amendments, administering the plan, and determining that the plan's transactions that are presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants, to determine the benefits due or which may become due to such participants.

Auditor's Responsibilities for the Audit of the Financial Statements

Except as described in the Scope and Nature of the ERISA Section 103(a)(3)(C) Audit of the Financial Statements section of our report, our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

a. Exercise professional judgment and maintain professional skepticism throughout the audit.
b. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
c. Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC 401(k) Plan's internal control. Accordingly, no such opinion is expressed.
d. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
e. Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for a reasonable period of time.

Auditor's Responsibilities for the Audit of the Financial Statements (Continued)

Our audit did not extend to the certified investment information, except for obtaining and reading the certification, comparing the certified investment information with the related information presented and disclosed in the financial statements, and reading the disclosures relating to the certified investment information to assess whether they are in accordance with the presentation and disclosure requirements of accounting principles generally accepted in the United States of America.

Accordingly, the objective of an ERISA Section 103(a)(3)(C) audit is not to express an opinion about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Other Matters – Supplemental Schedules Required by ERISA

The supplemental schedules of [*identify the title of supplemental schedules and periods covered*], are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information included in the supplemental schedules, other than that agreed to or derived from the certified investment information, has been subjected to auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS. For information included in the supplemental schedules that agreed to or is derived from the certified investment information, we compared such information to the related certified investment information.

In forming our opinion on the supplemental schedules, we evaluated whether the supplemental schedules, other than the information agreed to or derived from the certified investment information, including their form and content, are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.

In our opinion:

a. The form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA.
b. The information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

III. Acceptable modifications to standard report

AU-C Section 705 addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with this SAS, the auditor concludes that a modification to the auditor's opinion on the ERISA plan financial statements is necessary.

In the case of an ERISA Section 103(a)(3)(C) audit, the auditor should apply the requirements in AU-C Section 705, adapted as necessary in the circumstances of the engagement, including the following:

a. When the auditor expresses a qualified opinion due to a material misstatement of the financial statements, the auditor should amend the Opinion section to state that, in the auditor's opinion, except for the effects of the matters described in the Basis for Qualified Opinion section, based on the audit and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:
   (i) The amounts and disclosures in the other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with the applicable financial reporting framework; and
   (ii) The information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase "except for the possible effects of the matter(s)…" for the modified opinion.

a. **When the auditor expresses an adverse opinion, the requirements in paragraph 105 do not apply**, and the auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matters described in the Basis for Adverse Opinion section, the financial statements are not presented fairly in accordance with the applicable financial reporting framework.
b. When the auditor expresses a qualified or an adverse opinion, the auditor should amend the description in the Basis for Opinion section to state whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified ERISA Section 103(a)(3)(C) audit opinion.
c. When the auditor disclaims an opinion, the auditor should amend the statement required by paragraph 103b, which indicates that the auditor performed an audit of the financial statements, to state that the auditor was engaged to perform an audit of the financial statements. The auditor should also amend the description of the auditor's responsibility for the audit of the financial statements and the description of the scope of the audit to state only the following: "Our responsibility is to conduct an audit of the plan's financial statements in accordance with auditing standards generally accepted in the United States of America and to issue an auditor's report. However, because of the matters described in the Basis for Disclaimer of Opinion section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements."
d. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the requirements in paragraph 105 do not apply, and the auditor should state in the Disclaimer of Opinion section that:
   (i) Because of the significance of the matters described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and
   (ii) Accordingly, the auditor does not express an opinion on the financial statements.

A. Reporting on ERISA-required supplemental schedules when reporting under an ERISA Section 103(a)(3)(C) audit

In addition to the procedures performed during the audit of the ERISA plan financial statements (including the procedures required by paragraph 32), in order to report on the ERISA-required supplemental schedules when reporting under an ERISA Section 103(a)(3)(C) audit, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements:

a. Determine whether the form and content of the ERISA-required supplemental schedules, other than the information that agreed to or is derived from the certified investment information, is presented in conformity with the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA.

b. Compare and reconcile the information included in the ERISA-required supplemental schedules, other than that agreed to or derived from the certified investment information to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves.

c. Obtain written representations from management that it:
   (i) Acknowledges its responsibility for the presentation of the ERISA-required supplemental schedules in accordance with the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA; and
   (ii) Believes the ERISA-required supplemental schedules, including their form and content, are presented in conformity with the DOL's Rules and Regulations for Reporting and Disclosure Under ERISA.

When management elects to have an ERISA Section 103(a)(3)(C) audit, the auditor should include an Other Matter paragraph in the ERISA Section 103(a)(3)(C) audit report that contains the following elements:

a. The title of the supplemental schedules and the periods covered;

b. A statement that the supplemental schedules are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA;

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

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

e. A statement that, for information included in the supplemental schedules that agreed to or is derived from the certified investment information, the auditor compared such information to the related certified investment information;

f. A statement that, in forming the auditor's opinion on the supplemental schedules, the auditor evaluated whether the supplemental schedules, other than the information agreed to or derived from the certified investment information, including their form and content, are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA;

g. A statement whether, in the auditor's opinion:
   (i) The form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA; and
   (ii) The information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C); and

h. If the auditor issues a qualified ERISA Section 103(a)(3)(C) opinion on the ERISA plan financial statements and the qualification has an effect on the ERISA-required supplemental schedules, a statement that, in the auditor's opinion, except for the effects of [*describe the matters by referring to the section in the auditor's report explaining the qualification*] on the supplemental schedules of [*identify the schedules*]:
   (i) The form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA; and
   (ii) The information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase "except for the possible effects of the matter(s)…" for the modified opinion.

a. If the auditor's report on the ERISA plan financial statements subject to ERISA Section 103(a)(3)(C) contains an adverse opinion or a disclaimer of opinion, the auditor is precluded from expressing an opinion on the supplemental schedules. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the ERISA-required supplemental schedules. If the auditor does not withdraw, the auditor should do the following:
   (i) Include a statement that the supplemental schedules are presented for the purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure Under ERISA;
   (ii) Include a statement that such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements; and

(iii) Include a statement that because of the significance of the matter described in [*refer to the Basis for Adverse Opinion or Basis for Disclaimer of Opinion sections, as applicable*], it is inappropriate to, and the auditor does not express an opinion on the supplemental schedules.

B. Prior period financial statements not audited

When current period financial statements are audited and presented in comparative form with financial statements for the prior period for which a compilation or review was performed, and the report on the prior period is not reissued, the auditor should include an Other Matter paragraph in the current period auditor's report that includes the following with respect to the prior period:

a. The service performed in the prior period;
b. The date of the report on that service;
c. A description of any material modifications noted in that report;
d. For a review engagement, a statement that the service was substantially less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements as a whole; and
e. For a compilation engagement, a statement that no opinion or other form of assurance is expressed on the financial statements.

If the prior period financial statements were not audited, reviewed, or compiled, the financial statements should be clearly marked to indicate their status, and the auditor's report should include an Other Matter paragraph to indicate that the auditor has not audited, reviewed, or compiled the prior period financial statements and that the auditor assumes no responsibility for them.

C. Terminating plans

FASB ASC 962-40 provides guidance for terminating plans. Terminating plans include any plan about which a decision to terminate has been made, regardless of whether the terminated plan will be replaced.

When the decision to terminate a plan has been made or a wasting of trust exists, the relevant circumstances should be disclosed in all subsequent financial statements issued by the plan. A wasting trust is a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits.

If the decision to terminate a plan is made before the end of the plan year, then the plan's year-end financial statements should be prepared on the liquidation basis of accounting.

The auditor may express an unqualified opinion on financial statements prepared on the liquidation basis of accounting, provided the basis has been properly applied and that adequate disclosures are made in the financial statements.

Note:

Update 11-1 ***Accounting and Reporting*****: Liquidation Basis of Accounting:** FASB Auditing Standards Update (ASU) No. 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, is effective for entities that determine liquidation is imminent during annual reporting periods beginning on or after December 15, 2013, and interim reporting periods therein. Entities should apply the requirements prospectively from the day that liquidation becomes imminent. If adopting this ASU early, see the guidance in section G.01 in appendix G.

This ASU was issued in April 2013 and contains amendments to FASB ASC 205, *Presentation of Financial Statements*, that require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Early adoption is permitted.

The following is an illustration of the Emphasis of Matter paragraph when the auditor wants to emphasize that a defined contribution (DC) plan is being terminated. The Emphasis of Matter paragraph should be included immediately after the Opinion paragraph. Circumstances include the following:

a. An auditor's report on a full-scope audit of a DC plan whose financial statements are prepared in accordance with U.S. GAAP.
b. The auditor has included an Emphasis of Matter paragraph in the auditor's report to emphasize that the plan is being terminated.

Emphasis of matter

As further discussed in Notes A and B to the financial statements, the board of directors of XYZ Company, the plan's sponsor, voted on November 9, 2020, to terminate the plan. In accordance with accounting principles generally accepted in the United States of America, the plan has changed its basis of accounting from the ongoing plan basis used in presenting the 2019 financial statements to the liquidation basis used in presenting the 2020 financial statements. Our opinion is not modified with respect to this matter.

Financial Statement Issues and Disclosures

Financial Statement Issues and Disclosures

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Understand the financial statements and required disclosures; and
- Identify issues that may be encountered that require disclosure.

I. Financial statement issues

The required financial statements for a defined contribution 401(k) plan include the statement of net assets available for benefits and the statement of changes in net assets available for benefits. The statements can be prepared in accordance with the accrual basis or cash basis of accounting. In a previous chapter, the format of the financial statements was presented and discussed. In this chapter, various issues that have an impact on the financial statements will be discussed.

A. Initial audit

For an established plan that has triggered the audit requirement for the first time or a plan that was just created or a change in auditors, the initial audit procedures are the same. The beginning balances must be tested in total as well as at the participant level to ensure that the plan has consistently applied the same accounting procedures from one year to the next. If the plan sponsor has amended the plan or changed service providers, then the auditor should factor these changes into the determination of the level of testing necessary for the beginning balances.

Discussion question:

In order to test beginning balances, the auditor should request plan information for the prior year. Should the auditor ask for more plan information beyond the immediate prior year? If so, how many years' worth of information should be requested?

One of the first questions that auditors typically ask is, "How many years in the past are required to be tested?" The best answer is that auditors must use their own professional judgment to determine how many years in the past they need to request and examine to assist in their determination that the current year activity and balances are reasonable. Instead of asking how many previous years need to be tested, the questions that the auditor should ask include how many times the service provider has changed; have the investment options changed; were there any changes in the employer contribution; were there any plan amendments; etc.

B. Timeliness of remitting participant contributions

Timely remittance of participant contributions and loan payments is a high priority topic for the DOL and has been for many years. One of the issues with the timeliness of participant contributions and loan payments is that auditors are often placed in the position of determining whether or not a remittance is untimely. The guidelines from the DOL state that the amounts withheld from the participant's wages must be remitted as soon as reasonably possible but in no event more than the 15th business day following the month in which they were withheld. However, the concept of as soon as reasonably possible may be different from one plan to the next.

For example, the plan sponsor may state that the amounts withheld can be remitted on the fourth day following the date they were withheld. However, the plan sponsor is required to pay the federal tax deposit on the third day after each pay date. The question then becomes whether or not the auditor considers every remittance after the day they are withheld or after the third day as late and reports them on the supplemental schedule of delinquent contributions.

Unfortunately, there is not a single correct answer because there may be legitimate reasons that that particular plan sponsor cannot remit until the fourth day. The plan sponsor will be responsible for substantiating that it takes four days to remit the amounts withheld from employees in the event of an audit by the DOL. The auditor must evaluate the information provided by the plan sponsor, and using their professional judgment, determine if and when the amounts withheld and remitted are late.

If the auditor determines that the amounts remitted are not timely, then the contributions must be reported on the supplemental schedule of delinquent contributions, disclosed in the notes to the financial statements, reported on Line 4a of the Form 5500 Schedule H Part IV.

Sample disclosures for delinquent remittances of employee contributions and loan payments:

Note X: Delinquent contributions

As required by ERISA Section 2510.3-102, the plan sponsor is required to segregate employee contributions to the plan from its general assets as soon as practicable but in no event more than 15 business days following the end of the month in which amounts are withheld from wages. Due to the change in plan administrator from ABC to DEF during the fourth quarter of 20X2 (see note 8), contributions from the November 30, 20X2, payroll were not able to be transferred to, and accepted by, the new third party plan administrator (DEF) until December 30, 20X2, which exceeded the 15-business day limitation by seven business days. Total contributions and loan repayments for the November 30, 20X2, pay period were $60,160, of which $28,780 represented employee contributions; $27,681 represented the company's matching contributions; and $3,699 represented loan repayments. Contributions for this pay period are considered a prohibited transaction. The company made an interest payment of $2,587 to compensate the plan for lost investment earnings relating to this prohibited transaction. There were no prohibited transactions during 20X2.

Note X: Party in interest transaction

During 20X2, the plan sponsor did not remit certain participant contributions to the plan in a timely manner, as defined by ERISA. These instances were corrected during 20X2. These contributions are considered nonexempt party-in-interest transactions, which may result in an imposition of a 15 percent excise tax on the amount of the transactions. The plan sponsor intends to compensate participants for any lost interest resulting from the delay in contributions. Management estimates that lost income associated with the delay in contributions amounts to $147, computed at a 10.5 percent interest rate. These nonexempt transactions do not affect the tax status determination of the plan, and the company intends to pay all fines imposed.

C. Fair value disclosures

The information discussed below is only intended to summarize concepts in FASB ASC 820. Due to the fact that investments are usually the most significant item on the statement of net assets available for benefits, practitioners should refer to FASB ASC 820 for more complete information on fair value measurement.

FASB ASC 820, *Fair Value Measurement*, defines fair value, sets out a framework for measuring fair value, and requires certain disclosures about fair value measurements. In order to be in compliance with the requirements of FASB ASC 820 a significant amount of coordination must be taken into consideration, which includes coordination among plan management, custodians, investment managers, and plan auditors.

Plan sponsors and plan administrators will need to determine whether they have the appropriate valuation processes in place and sufficient data to determine the fair value of the plan's investments and to present the required disclosures about fair value measurements. Although plan management can outsource the mechanics of the valuation process, they need to retain responsibility for the oversight of the final valuations, including determining the adequacy of the related note disclosures.

1. Definition of fair value

FASB ASC 820-10-20 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

FASB ASC 820-10-35-37 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value. The three levels are discussed in:

a. Paragraphs 40-41 of FASB ASC 820-10-35, which state that level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market, as defined by the FASB ASC glossary, is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as specified in FASB ASC 820-10-35-41C.

b. Paragraphs 47-51 of FASB ASC 820-10-35, which explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset, the extent to which inputs relate to items that are comparable to the asset or liability, and the volume or level of activity in the markets within which the inputs are observed. An adjustment to a level 2 input that is significant to the entire measurement might result in a fair value measurement categorized within level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs. Level 2 inputs include the following:

   (i) Quoted prices for similar assets or liabilities in active markets;

   (ii) Quoted prices for identical or similar assets or liabilities in markets that are not active;

   (iii) Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, implied volatilities, and credit spreads); and

   (iv) Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means (market-corroborated inputs).

c. Paragraphs 52-54A of FASB ASC 820-10-35, which state that level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the related asset or liability. FASB ASC 820-10-55-21 and FASB ASC 820-10-55-22 provide examples of level 2 and level 3 inputs, respectively, for particular assets and liabilities.

FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. FASB ASC 820-10-50-1 requires the reporting entity to disclose certain information that helps users of its financial statements to assess both: (i) the valuation techniques and inputs used to develop those measurements for assets and liabilities that are measured at fair value on a recurring or nonrecurring basis after initial recognition; and (ii) for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings (or changes in net assets) or other comprehensive income for the period.

Following is a sample footnote disclosure for fair value measurement.

Note X: Fair Value Measurements

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy under FASB ASC 820 are described as follows.

Level 1	Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the plan has the ability to access.
Level 2	Inputs to the valuation methodology include: a. Quoted prices for similar assets or liabilities in active markets; b. Quoted prices for identical or similar assets or liabilities in inactive markets; c. Inputs other than quoted prices that are observable for the asset or liability; and d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
Level 3	Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 20X7 and 20X6.

a. **Common stocks** – Valued at the closing price reported on the active market on which the individual securities are traded.
b. **Corporate bonds** – Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.
c. **Mutual funds** – Valued at the daily closing price as reported by the fund. Mutual funds held by the plan are open-end mutual funds that are registered with the SEC. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the plan are deemed to be actively traded.
d. **Collective trust fund** – Valued at the NAV of units of a bank collective trust. The NAV, as provided by the trustee, is used as a practical expedient to estimate fair value. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. This practical expedient is not used when it is determined to be probable that the fund will sell the investment for an amount different than the reported NAV. Participant transactions (purchased and sales) may occur daily. Were the plan to initiate a full redemption of the collective trust, the investment adviser reserves the right to temporarily delay withdrawal from the trust in order to ensure that securities liquidations will be carried out in an orderly business manner.
e. **U.S. government securities** – Valued using pricing models maximizing the use of observable inputs for similar securities.

Note:

The methodologies noted above would only be included as applicable to the plan.

The table below is presented based on the assumption that the investments are measured at **net asset value as a practical expedient**.

	Assets at Fair Value as of December 31, 20X5			
	Level 1	Level 2	Level 3	Total
Mutual funds	$4,437,500			$4,437,500
Self-directed brokerage account	25,000			25,000
Common stocks:	960,000			960,000
Corporate bonds (Aaa credit rating)	---	307,500	20,000	327,500
U.S. government securities	---	225,000	---	225,000
Total assets in FV hierarchy	$5,422,500	$532,500	$20,000	$5,975,000
Investments measured at net asset value	---	---	---	1,422,000
Total investments	$5,422,500	$532,500	$20,000	$7,397,000

	Assets at Fair Value as of December 31, 20X4			
	Level 1	Level 2	Level 3	Total
Mutual funds	$3,337,500			$3,337,500
Self-directed brokerage account	25,000			25,000
Common stocks:	960,000			960,000
Corporate bonds (Aaa credit rating)	---	207,500	20,000	227,500
U.S. government securities	---	125,000	---	125,000
Total assets in FV hierarchy	$4,322,500	$332,500	$20,000	$4,675,000
Investments measured at net asset value	---	---	---	1,322,000
Total investments	$4,322,500	$332,500	$20,000	$5,997,000

Transfers between levels: For the years ending December 31, 20X5 and 20X4, there were no significant transfers between levels 1 and 2 and no transfers in or out of level 3.

Changes in fair value of level 3 assets and related gains and losses: The following sets forth a summary of changes in the fair value of the plan's Level 3 assets for the year ended December 31, 20X5.

a. As of December 31, 20X5, purchases of level 3 assets totaled $0, sales totaled $1,500 and transfers in/out of level 3 were $0, net.

Quantitative information about significant unobservable inputs used in level 3 fair value measurements: The following table represents the plan's level 3 financial instruments, the valuation techniques used to measure the fair value of those financial instruments, and the significant unobservable inputs and the ranges of values for those inputs.

Instrument	Fair Value	Principal Valuation Technique	Unobservable Inputs	Range of Significant Input Values	Weighted Average
Corporate bonds	$20,000	Discounted cash flow	Credit risk (basis points)	XX-XXX	Y%
			Liquidity risk (basis points)	XX-XXX	Y%

Fair value of investments in entities that use NAV: The following table summarizes investments measured at fair value based on NAV per share as of December 31, 2020, and 2019, respectively.

December 31, 20X5	Fair Value	Unfunded Commitments	Redemption Frequency (if currently eligible)	Redemption Notice Period
Collective trust fund – S&P 500	$1,422,000	N/A	Daily	12 months
December 31, 20X4	**Fair Value**	**Unfunded Commitments**	**Redemption Frequency (if currently eligible)**	**Redemption Notice Period**
Collective trust fund – S&P 500	$1,322,000	N/A	Daily	12 months

Note:

> The examples above have been presented assuming that the investments are measured at net asset value as a practical expedient in accordance with ASU 2015-07. However, in the event that the plan sponsor deems the investments to be valued at net asset value as readily determinable fair value then the investments will remain in the fair value hierarchy. The investments would be classified as either a level 1 or 2 investment as determined by the plan sponsor.

Example of fair value hierarchy with investments measured at **net asset value as readily determinable fair value (common collective trust):**

	Assets at Fair Value as of December 31, 20X5			
	Level 1	Level 2	Level 3	Total
Mutual funds:	$4,437,500			$4,437,500
Common collective trust		$1,422,000		1,422,000
Self-directed brokerage account	25,000			25,000
Common stocks	960,000			960,000
Corporate bonds (AAA credit rating)	---	307,500	20,000	327,500
U.S. government securities	---	225,000	---	225,000
Investments at fair value	$5,422,500	$1,954,500	$20,000	$7,397,000

D. Subsequent events

Activities that occur after the plan's year-end but before the issuance of the financial statements should be disclosed as a subsequent event. If the plan changes trustees or the plan is amended after year-end, then the events should be disclosed as a subsequent event.

Due to the timing of the fieldwork and audit procedures associated with most benefit plan audits, the subsequent event period can be lengthy. Plan auditors should perform procedures to ensure that events that occurred subsequent to year-end but prior to the issuance of the financial statements are properly disclosed and accounted for in the financial statements. ASC 855-10, *Subsequent Events* (formerly SFAS 165), requires auditors to disclose the date through which subsequent events have been evaluated and whether that date is the same as the date the financial statements were issued or were available to be issued. Auditors are required to include this disclosure regardless of whether or not any subsequent events were recognized or disclosed in the financial statements. Procedures include inquiry of plan management, reading the minutes of board meetings subsequent to year-end, and reviewing trustee statements for the periods following year-end. The following are some of the more common subsequent event items that occur in benefit plan audits.

a. Plan amendments;
b. Change in custodian;
c. Change in investment offerings;
d. Plan mergers or acquisitions; and
e. Plan termination.

Sample disclosures for subsequent events include:

Note X: Subsequent events

> The plan administrator has evaluated subsequent events through June 20, 20X5, the date the financial statements were available to be issued.

Note X: Subsequent events

On February 16, 20X6, the boards of directors of ABC Holdings, Inc. (Holdings); ABC Management, Inc. (Management); and ABC Operations Inc. (Operations) approved resolutions that resulted in the adoption of the ABC Holdings, Inc., profit-sharing plan and trust by Management and Operations, which was renamed the plan ABC 401(k) profit-sharing plan and trust (plan). Effective February 16, 20X6, all the employees of Holdings became employees of Management or Operations. The boards also approved the change in the signatory employer from Holdings to Operations.

On February 16, 20X6, the board of directors of Operations approved the merger of the ABC Operations money purchase pension plan and trust into the plan.

Note X: Subsequent events

The plan changed the trustee to ABC Trust Company and adopted a new plan document that amends and restates the plan, effective June 1, 20X6. The company has not yet requested or received a determination letter for the new plan document. The company believes that the provisions under the new plan document are in compliance with the applicable requirements of the Internal Revenue Code.

Note X: Subsequent events

On March 8, 20X6, the plan was amended to allow the transfer of the account balances of the ABC profit sharing plan and trust, which was terminated January 1, 20X5, into the plan. On March 19, 20X6, $2,828,654 was transferred to the plan.

On April 16, 20X6, an amendment to the plan changed the definition of an eligible employee. An employee who has been employed for 90 days from the date of hire is considered an eligible employee, effective the first day of the month following the 90-day anniversary. This amendment was effective May 1, 20X6.

1. Subsequent event disclosures

Entities may need to evaluate whether the consequences of COVID-19 represent subsequent events. FASB Accounting Standards Codification (FASB ASC) 855, *Subsequent Events*, defines subsequent events as events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued1. There are two types of subsequent events:

a. The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (that is, recognized subsequent events); and
b. The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (that is, nonrecognized subsequent events).

Recognized and nonrecognized subsequent events, as defined in FASB ASC 855, correspond to the two types of subsequent events described in U.S. generally accepted auditing standards (U.S. GAAS) found in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*. Those two types of subsequent events are:

a. Events that provide evidence of conditions that existed at the date of the financial statements (historically referred to as Type I subsequent events); and
b. Events that provide evidence of conditions that arose after the date of the financial statements (historically referred to as Type II subsequent events).

2. Risks and uncertainties disclosures

FASB ASC 275, *Risks and Uncertainties*, requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations. The effects of COVID-19 may negatively impact significant estimates and exacerbate a vulnerability due to certain concentrations (e.g., business concentration in a market severely affected by the effects of COVID-19).

II. Required disclosures

A. Basic footnote disclosures

The items listed below are required to be disclosed in the notes to the financial statements for a defined contribution benefit plan, as applicable.

a. General description of the plan;
b. Summary of significant accounting policies;
c. Plan's tax status;
d. Plan termination;
e. Master trust information if the plan participates in a master trust;
f. Risks and uncertainties;
g. Plan mergers and terminations;
h. Party-in-interest transactions;
i. Subsequent events;
j. Limited scope information;
k. Plan amendments adopted during the year;
l. Form 5500 reconciliations, as necessary; and
m. Information about the purchase of contracts with insurance company.

The plan's financial statements should include in the footnotes a general description of the plan and its pertinent attributes. The description will usually include participation requirements, contributions, participant loan provisions, vesting requirements, investment options, participant accounts, forfeitures, and other information as considered necessary to assist the reader in understanding the nature of the plan.

Presented below is a sample set of financial statements disclosures for a defined contribution 401(k) plan.

1. Description of plan

The following description of the Retirement Savings Plan for Hourly Employees of Company, Inc. (Plan) provides only general information. Participants should refer to the Plan document for a more complete description of the Plan's provisions.

General – The Company established the Plan to provide employees with a systematic means of savings and investing for the future. Regular full-time, hourly employees of the Company, as defined by the Plan document, are eligible to enroll on their date of hire. Deferrals begin on the first day of the month subsequent to enrollment.

On December 29, 2022, President Biden signed into law the Consolidated Appropriations Act of 2023, which includes the package of retirement provisions referred to as “SECURE 2.0”. These provisions continue the themes and reforms that began with the 2019 SECURE Act, focusing on getting more participants into the retirement system, finding ways for them to accumulate more assets, and then ensuring they get connected with those assets when retirement comes.

Many of the provisions of the SECURE 2.0 are effective on January 1, 2023, and beyond and will require significant changes to plan administration and recordkeeping.

The Plan is a defined contribution plan subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

Assets of the Plan are allocated to participant accounts based on specific contributions made by each participant and respective matches made by the Company. Investment income (loss) is credited to each account based on appreciation (depreciation) of specific assets held in each participant account and any earnings thereon.

Plan Contributions – Participants may contribute from 1 percent to 25 percent of their base pay by means of payroll deductions, subject to certain discrimination tests prescribed by the Internal Revenue Code and other limitations specified in the Plan. The Company matches either 50 percent or 100 percent of employee contributions of 3 percent to 6 percent of base pay payroll period. Effective June 1, 20X2, the Company amended the Plan to add a Roth contribution feature. Upon determination of participants' contributions, the Company contributions are made to the trustee in cash. The contributed cash is allocated to individual employee accounts and invested at the participants' direction.

Participant Accounts – Each participant's account is credited with the participant's contributions, allocations of the Company's matching contributions, and Plan gains or losses. Allocations of earnings and losses for each fund are based on the ratio of weighted average participant account balances per fund to the total weighted average of all participant account balances. The benefit to which a participant is entitled is the vested benefit that can be provided from the participant's accounts.

Investment Options – Upon enrollment in the Plan, participants direct the investment of their contributions and Company contributions into various investment options offered by the Plan. Participants may direct their contributions into one or more mutual funds, a money market fund, and a self-directed brokerage account.

Vesting – Participants are immediately vested in their voluntary contributions, company matching contributions, and actual earnings thereon. However, vesting in Company matching contributions is based on years of service. Prior to normal retirement age, a participant's interest in the contributions of the employer becomes 100 percent vested after three years of service.

Distributions – Upon retirement, disability or death, a participant or beneficiary receives the entire amount credited to the participant's account in either a lump sum or, at the participant's election, in annual installments. Upon termination, other than by retirement, disability or death, a participant becomes eligible to receive the current value of the participants' vested account in a lump-sum.

Participant Notes Receivable – Participants may borrow from their account balances with interest charged at a rate equal to the “prime rate” plus 1 percent, which remains in effect for the duration of the loan. Loan terms range from 1 to 5 years or up to 25 years for the purchase of a primary residence. The minimum loan is $1,000 and the maximum loan is the lesser of $50,000 less the highest outstanding loan balance during the one-year period prior to the new loan application date, or 50 percent of the participant’s account balance less any current outstanding loan balance. The loans are secured by the balance in the participants’ account. Principal and interest are paid ratably through payroll deductions. Participants may only take out one loan during any 12-month period and may only have two loans outstanding at any time. As of December 31, 20X5 and 20X4, the Plan had loans receivable from participants with principal balances totaling $2,721,875 and $2,674,691, respectively, which are included with investments in the accompanying Statements of Net Assets Available for Benefits.

Participant Investment Rollovers – Participants are allowed to transfer or rollover funds into the Plan from other qualified plans.

2. Summary of significant accounting policies

A plan is also required to disclose significant accounting policies such as the basis of accounting, investments, non-readily marketable securities (if applicable), and the use of estimates. A summary of significant accounting policies is included below.

Basis of Accounting – The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with generally accepted accounting principles in the United States of America.

Investments held by a defined contribution plan are required to be reported at fair value, except for fully benefit responsive investment contracts. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined contribution plan attributable to fully benefit-responsive investment contracts because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan.

Use of Accounting Estimates – The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of certain assets, liabilities, and disclosures. Accordingly, the actual amounts could differ from those estimates. Any adjustments applied to estimated amounts are recognized in the year in which such adjustments are determined.

Investment Valuation and Income Recognition – Investments are reported at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Plan’s Investment Committee determines the Plan’s valuation policies utilizing information provided by the investment advisers, custodians, and insurance company. See note E for discussion of fair value measurements.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date. Net appreciation includes the Plan’s gains and losses on investments bought and sold as well as held during the year.

Management fees and operating expenses charged to the Plan for investments in mutual funds are deducted from income earned on a daily basis and are not separately reflected. Consequently, management fees and operating expenses are reflected as a reduction of net appreciation in fair value of investments.

The change in net unrealized appreciation/depreciation of investments held from the beginning of the plan year to the end of the plan year is included with realized gains/losses as net investment income/loss reported in the accompanying statements of changes in net assets available for benefits.

Notes Receivable From Participants – Notes receivable from participants are measured at their unpaid principal balance plus any accrued but unpaid interest. Interest income is recorded on the accrual basis. Related fees are recorded as administrative expenses and are expensed when they are incurred. No allowance for credit losses has been recorded as of December 31, 20X5 or 20X4.

Excess Contributions Payable – Amounts payable to participants for contributions in excess of amounts allowed by the IRS are recorded as a liability with a corresponding reduction to contributions. The Plan distributed the 2025 excess contributions to the applicable participants prior to March 15, 2026.

Payment of Benefits – Benefits are recorded when paid.

Expenses – Certain expenses of maintaining the Plan are paid by the Plan, unless otherwise paid by the Company. Expenses that are paid by the Company are excluded from these financial statements. Fees related to the administration of notes receivable from participants are charged directly to the participant's account and are included in administrative expenses. Investment related expenses are included in net appreciation of fair value of investments.

Subsequent Events – The Plan has evaluated subsequent events through [*insert date*], the date the financial statements were available to be issued.

3. Investments (unaudited)

The Plan's investments were held in trust and administered by the Trustee. All investment information presented in the accompanying financial statements and supplemental schedules, including investments held and net appreciation/depreciation in fair value of investments and interest and dividends, was obtained or derived from information supplied to the Plan Administrator and certified as complete and accurate by the Trustee.

4. Fair value measurement

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy under FASB ASC 820 are described as follows:

Level 1	Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Plan has the ability to access.
Level 2	Inputs to the valuation methodology include: a. Quoted prices for similar assets or liabilities in active markets; b. Quoted prices for identical or similar assets or liabilities in inactive markets; c. Inputs other than quoted prices that are observable for the asset or liability; and d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
Level 3	Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 20X5 and 20X4.

a. **Common stocks** – Valued at the closing price reported on the active market on which the individual securities are traded.
b. **Corporate bonds** – Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.
c. **Mutual funds** – Valued at the daily closing price as reported by the fund. Mutual funds held by the Plan are open-end mutual funds that are registered with the SEC. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Plan are deemed to be actively traded.
d. **U.S. government securities** – Valued using pricing models maximizing the use of observable inputs for similar securities.
e. **Guaranteed investment contract** – Guaranteed investment contracts are valued at contract value by the insurance company by discounting the related cash flows based on current yields of similar instruments with comparable durations considering the creditworthiness of the issuer. In determining the reasonableness of the methodology, the Investment Committee evaluates a variety of factors including review of existing contracts, economic conditions, industry and market developments, and overall credit ratings. Certain unobservable inputs are assessed through review of contract terms (for example, duration or payout date) while others are substantiated utilizing available market data (for example, swap curve rate).

The following table sets forth by level, within the fair value hierarchy, the Plan's assets at fair value as of December 31, 20X2 and 20X1, with investments measured at net asset value as a practical expedient.

	Assets at Fair Value as of December 31, 20X5			
	Level 1	Level 2	Level 3	Total
Mutual funds	$4,437,500			$4,437,500
Self-directed brokerage accounts	25,000			25,000
Common stock	960,000			960,000
U.S. government securities		225,000		225,000
Corporate bonds		307,500	20,000	327,500
Total assets in FV hierarchy	5,422,500	532,500	20,000	5,975,000
Investments measured at net asset value	—	—	—	1,422,000
Investments at fair value	$5,422,500	$ 532,500	$ 20,000	$7,397,000

	Assets at Fair Value as of December 31, 20X4			
	Level 1	Level 2	Level 3	Total
Mutual funds	$3,630,000			$3,630,000
Self-directed brokerage accounts	20,000			20,000
Common stock	870,000			870,000
U.S. government securities		120,000		120,000
Corporate bonds		255,000	19,000	274,000
Total assets in FV hierarchy	4,520,000	375,000	19,000	4,914,000
Investments measured at net asset value	—	—	—	2,100,000
Investments at fair value	$4,520,000	$ 375,000	$ 19,000	$7,014,000

The following is a summary of changes in the fair value of the Plan's level 3 assets for the year ended December 31, 20X5.

As of December 31, 20X5, purchases of level 3 assets totaled $0, sales totaled $1,500 and transfers in/out of level 3 were $0, net.

Quantitative Information About Significant Unobservable Inputs Used in Level 3 Fair Value Measurements: The following table represents the Plan's level 3 financial instruments, the valuation techniques used to measure the fair value of those financial instruments, and the significant unobservable inputs and the ranges of values for those inputs.

Instrument	Fair Value	Principal Valuation Technique	Unobservable Inputs	Range of Significant Input Values	Weighted Average
Corporate bonds	$20,000	Discounted cash flow	Credit risk (basis points)	xx-xxx	Y%
			Liquidity risk (basis points)	xx-xxx	Y%

Fair Value of Investments in Entities That Use NAV: The following table summarizes investments measured at fair value based on NAV per share as of December 31, 20X5 and 20X4, respectively.

December 31, 20X5	Fair Value	Unfunded Commitments	Redemption Frequency (if currently eligible)	Redemption Notice Period
Collective trust fund – S&P 500	$1,422,000	N/A	Daily	12 months
December 31, 20X4	**Fair Value**	**Unfunded Commitments**	**Redemption Frequency (if currently eligible)**	**Redemption Notice Period**
Collective trust fund – S&P 500	$2,100,000	N/A	Daily	12 months

5. Investment contract with insurance company

The Plan holds a portfolio of investment contracts that comprises a traditional investment contract and a portfolio of synthetic investment contracts. These contracts meet the fully benefit-responsive investment contract criteria and therefore are reported at contract value. Contract value is the relevant measure for fully benefit-responsive investment contracts because this is the amount received by participants if they were to initiate permitted transactions under the terms of the Plan. Contract value represents contributions made under each contract, plus earnings, less participant withdrawals, and administrative expenses. The following represents the disaggregation of contract value between types of investment contracts held by the Plan.

	20X5	20X4
Synthetic investment contracts	$ 1,250,000	$ 500,000
Traditional Investment contract	250,000	150,000
Total	$ 1,500,000	$ 650,000

The key difference between a synthetic investment contract and a traditional investment contract is that the Plan owns the underlying assets of the synthetic investment contract. A synthetic investment contract includes a wrapper contract, which is an agreement for the wrap issuer, such as a bank or insurance company, to make payments to the Plan in certain circumstances. The wrapper contract typically includes certain conditions and limitations on the underlying assets owned by the Plan. With traditional investment contracts, the Plan owns only the contract itself. Synthetic and traditional investment contracts are designed to accrue interest based on crediting rates established by the contract issuers.

The synthetic investment contracts held by the Plan include wrapper contracts that provide a guarantee that the credit rate will not fall below 0 percent. Cash flow volatility (for example, timing of benefit payments) as well as asset underperformance can be passed through to the Plan through adjustments to future contract crediting rates. Formulas are provided in each contract that adjusts renewal crediting rates to recognize the difference between the fair value and the book value of the underlying assets. Crediting rates are reviewed monthly for resetting.

The traditional investment contract held by the Plan is a guaranteed investment contract. The contract issuer is contractually obligated to repay the principal and interest at a specified interest rate that is guaranteed to the Plan. The crediting rate is based on a formula established by the contract issuer but may not be less than 4 percent. The crediting rate is reviewed on a quarterly basis for resetting. The contract cannot be terminated before the scheduled maturity date.

The Plan's ability to receive amounts due in accordance with fully benefit responsive investment contracts is dependent on the third-party issuer's ability to meet its financial obligations. The issuer's ability to meet its contractual obligations may be affected by future economic and regulatory developments.

Certain events might limit the ability of the Plan to transact at contract value with the contract issuer. These events may be different under each contract. Examples of such events include the following:

a. The Plan's failure to qualify under Section 401(a) of the Internal Revenue Code or the failure of the trust to be tax-exempt under Section 501(a) of the Internal Revenue Code.
b. Premature termination of the contracts.
c. Plan termination or merger.
d. Changes to the Plan's prohibition on competing investment options.
e. Bankruptcy of the plan sponsor or other plan sponsor events {for example, divestitures or spinoffs of a subsidiary) that significantly affect the Plan's normal operations.

No events are probable of occurring that might limit the ability of the Plan to transact at contract value with the contract issuers and that also would limit the ability of the Plan to transact at contract value with the participants.

In addition, certain events allow the issuer to terminate the contracts with the Plan and settle at an amount different from contract value. Those events may be different under each contract. Examples of such events include the following:

a. An uncured violation of the Plan's investment guidelines.
b. A breach of material obligation under the contract.
c. A material misrepresentation.
d. A material amendment to the agreements without the consent of the issuer.

6. Tax status

The Plan has received a determination letter from the Internal Revenue Service dated January 31, 2018, stating that the Plan is qualified under Section 401(a) of the Internal Revenue Code (the "Code") and, therefore, the related trust is exempt from taxation. Once qualified, the Plan is required to operate in conformity with the Code to maintain its qualification. The Plan was amended since receiving the determination letter. Plan management believes the Plan is currently designed and operated in compliance with the applicable requirements of the Code. Therefore, no provision for income tax has been included in the Plan's financial statements.

Accounting principles generally accepted in the United States of America require plan management to evaluate tax positions taken by the plan and recognize a tax liability (or asset) if the plan has taken an uncertain position that more likely than not would not be sustained upon examination by the applicable authorities. The plan is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

Other required disclosures are shown in the examples below and include the plan termination, party-in-interest transactions, risks and uncertainties, and reconciliation to the form 5500.

7. Plan termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. However, no such action may deprive any participant or beneficiary under the Plan of any vested right.

Note:

> Transactions with parties-in-interest must also be disclosed in the notes to the financial statements. There are certain transactions that qualify as a party-in-interest transaction but are not considered to be prohibited transactions.

8. Related-party and party-in-interest transactions

The Plan invests in common/collective trusts and registered investment companies sponsored by Trust Company, the Plan's Trustee, as defined by the Plan, and therefore, these transactions qualify as party-in-interest transactions. Administrative fees related to the Trustees' administration of the Plan are paid by the Plan. Other administrative fees are paid by the Plan sponsor on behalf of the Plan.

9. Risks and uncertainties

The plan's investments, in general, are subject to various risks, such as interest rate, credit, and overall market volatility risk. Additionally, the value, liquidity, and related income of the investment securities are sensitive to changes in economic conditions and may be affected by shifts in the market's perception of issuers and changes in interest rates. Certain investments (such as asset-backed securities, limited partnerships, and limited liability companies) are less liquid and may have restrictions on their sale. Forced liquidation, although not expected at this time, may affect the estimated value of such investments. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in the value of investments will occur in the near term and that such changes could materially affect the amounts reported in the statement of net assets available for benefits and the funded status of the plan.

Note:

> In accordance with SAS 136, the auditor should make appropriate arrangements with management to obtain the draft Form 5500. The auditor should obtain and read the draft Form 5500 prior to dating the auditor's report. The auditor should read the draft Form 5500 in order to identify material inconsistencies, if any, with the audited ERISA plan financial statements.
>
> The auditor should communicate with those charged with governance the auditor's responsibility with respect to Form 5500, procedures performed relating to Form 5500, and the results of those procedures.
>
> Certain differences may exist between the Form 5500 Schedule H, "Financial Information," and the ERISA plan financial statements. DOL rules and regulations require the notes to the ERISA plan financial statements to include an explanation of differences, if any, between the information contained in the separate ERISA plan financial statements and the net assets, liabilities, income, expense, and changes in net assets as required to be reported on the Form 5500 Schedule H, "Financial Information." There are some differences that are not considered inconsistencies with Form 5500, for example, differences resulting from accruals recorded in the ERISA plan financial statements that are not reported in Form 5500 when Form 5500 is on a cash basis or benefits payable required to be reported on Form 5500 but not recorded in the ERISA plan financial statements. In contrast, a difference in investment categories may be due to a misclassification that may require correction in either the ERISA plan financial statements or Form 5500.

10. Reconciliation of financial statements to form 5500

The following table is a reconciliation of net assets available for benefits per the financial statements to the Form 5500 as of December 31, 20X5 and 20X4:

Net assets available for benefits per the accompanying financial statements	$ 43,218,134	$ 40,287,274
Participant contributions receivable	(18,162)	(17,243)
Employer contribution receivable	(12,350)	(11,475)
Net assets available for benefits per the Form 5500	$ 43,187,622	$ 40,258,556

The following table is a reconciliation of the change in net assets available for benefits per the financial statements to the Form 5500 for the years ending December 31, 20X2 and 20X1:

	20X5	20X4
Change in net assets available for benefits per the accompanying financial statements	$ 3,030,596	$ 3,857,445
Current year contributions receivable	(30,512)	(28,718)
Prior year contributions receivable	28, 718	
Change in net assets available for benefits per the Form 5500	$ 3,028,802	$ 3,828,727

11. Subsequent events

The plan has evaluated subsequent events through ___________ (insert date), the date the financial statements were available to be issued.

B. Other disclosures

1. Excess contributions refundable

A liability is recorded on the financial statements for amounts contributed by participants and employers that are in excess of amounts allowed by the Internal Revenue Service. The footnotes should also include a disclosure that describes the amounts to be refunded.

Sample disclosure for excess contributions refundable:

> At December 31, 20X5 and 20X4, the Plan had $xx,xxx and $xx,xxx, respectively, recorded as excess contributions refundable to participants for contributions made in excess of amounts allowed by the Internal Revenue Service.

2. Benefit claims payable

The Plan does not record as liabilities benefit claims payable to participants that requested the withdrawal prior to December 31 but not paid until after January 1. However, these amounts should be disclosed in the notes to the financial statements. The auditor should also determine if the Form 5500 includes benefit claims payable because a reconciling footnote may be necessary if a liability is recorded on the Form 5500 and not the financial statements.

Benefits claims payable example:

> At December 31, 20X5 and 20X4, net assets available for benefits included $xx,xxx and $xx,xxx, respectively, for distributions to participants who have requested a distribution from the Plan prior to the end of the Plan year.

3. Plan mergers and terminations

The plan should disclose any decisions made to terminate the plan or merge with another qualified benefit plan. If the decision to terminate the plan is made before the end of the plan year, then the financial statements should be prepared on the liquidation basis of accounting. Liquidation basis accounting requires that the assets and liabilities be recorded at fair value. The auditor should also include a statement in the audit opinion regarding the decision to terminate the plan. However, if the decision to terminate the plan is made after the plan's year end, but before issuance of the financial statements, then footnote disclosure only is required.

Plan termination footnote example:

> On April 28, 2025, the Company's Board of Directors approved the termination of the ABC 401(k) Plan. As a result, all participant balances became fully vested. Assets were distributed to employees on or before December 31, 2025.

4. Concentrations

Concentration footnote example:

> As of December 31, 2025, and 2024, approximately 10 percent and 8 percent of the plan's assets were invested in ABC Learning, Inc., common stock, respectively. The underlying value of the growth fund is dependent on the performance of ABC Learning, Inc., and the market's evaluation of such performance. It is at least reasonably possible that changes in the fair value of ABC Learning, Inc., common stock in the near term could materially affect participants' account balances and the amounts reported in the statement of assets available for benefits and the statement of changes in assets available for benefits.

5. Commitments and contingencies

Commitments and contingencies example:

> From 1997 to January 20X3, the plan sponsor failed to register, in compliance with applicable securities laws, shares of the plan sponsor's common stock transferred to participants in its 401(k) plan and the interests of those participants in that plan, which also may be deemed securities requiring registration. The plan sponsor intends to offer a 30-day right of rescission to those participants who received shares of its common stock in violation of applicable securities laws during the two years preceding the date of the rescission offer, the statute of limitations period that the plan sponsor believes may apply to claims for rescission under applicable state laws, or possibly a longer or shorter period.
>
> Under the rescission offer, the participants will be entitled to require the plan sponsor to repurchase those shares at the price per share of the plan sponsor's common stock when the shares were transferred to the participant's account, plus interest at a rate to be determined.
>
> Based upon the plan sponsor's preliminary investigation, the plan sponsor currently believes that approximately 22,000 shares of its common stock were transferred to 401(k) plan participants since January 1, 20X2, in violation of applicable securities laws and if subject to its rescission offer, would have an aggregate repurchase price of approximately $301,000, plus interest. The plan sponsor also may face fines and other penalties for its violation of applicable securities laws and may be required to offer rescission to participants who received shares of the plan sponsor's common stock prior to the two-year period preceding the anticipated rescission offer.

In addition, applicable securities laws do not expressly provide that the plan sponsor's planned rescission offer will terminate a participant's right to rescind a sale of stock that was not properly registered. Accordingly, the plan sponsor may continue to have a contingent liability relating to the shares transferred to participants who do not accept the rescission offer, based upon the price per share of the plan sponsor's common stock when the shares were transferred to the participant's account.

Additional Considerations

Additional Considerations

Learning objectives

Upon reviewing this chapter, the reader will be able to:
- Understand how violations can be corrected in accordance with the DOL and the IRS;
- Prepare the appropriate communications to the plan sponsor at the completion of the audit; and
- Understand the current and future changes impacting employee benefit plans.

I. EBSA programs

The DOL has initiated a program to assess and improve the quality of employee benefit plan audits. According to statistics provided by the EBSA, there are a significant number of employee benefit plan audits and firms performing these audits. The EBSA utilizes a top-down and bottom-up strategy in selecting and evaluating ERISA audits.

A. Voluntary Fiduciary Correction Program

Discussion question:

What are some of the common errors and mistakes made by plan administrators?

The VFCP is designed to encourage employers to voluntarily comply with the Employee Retirement Income Security Act (ERISA) by self-correcting certain violations of the law. Anyone who may be liable for fiduciary violations under ERISA, including employee benefit plan sponsors, officials, and parties in interest, may voluntarily apply for relief from enforcement actions, provided they comply with the criteria and satisfy the procedures outlined in the VFCP. Persons using the VFCP must fully and accurately correct violations. Incomplete or unacceptable applications may be rejected. If rejected, applicants may be subject to enforcement action, including assessment of civil monetary penalties.

The information provided below is from a fact sheet provided by the DOL and can be found on their website. The VFCP provides descriptions of 19 categories of transactions and their methods of correction. Corrective remedies are prescribed for the following fiduciary violations involving employee benefit plans:

a. Delinquent Participant Contributions and Participant Loan Repayments to Pension Plans.
b. Delinquent Participant Contributions to Insured Welfare Plans.
c. Delinquent Participant Contributions to Welfare Plan Trusts.
d. Fair Market Interest Rate Loans to Parties in Interest.
e. Below Market Interest Rate Loans to Parties in Interest.
f. Below Market Interest Rate Loans to Non-Parties in Interest.
g. Below Market Interest Rate Loans Due to Delay in Perfecting Security Interest.
h. Participant Loans Failing to Comply with Plan Provisions for Amount, Duration, or Level Amortization.
i. Defaulted Participant Loans.
j. Purchase of Assets by Plans from Parties in Interest.
k. Sale of Assets by Plans to Parties in Interest.
l. Sale and Leaseback of Property to Sponsoring Employers.
m. Purchase of Assets from Non-Parties in Interest at More Than Fair Market Value.

n. Sale of Assets to Non-Parties in Interest at Less Than Fair Market Value.
o. Holding of an Illiquid Asset Previously Purchased by Plan.
p. Benefit Payments Based on Improper Valuation of Plan Assets.
q. Payment of Duplicate, Excessive, or Unnecessary Compensation.
r. Improper Payment of Expenses by Plan.
s. Payment of Dual Compensation to Plan Fiduciaries.

The VFCP provides rules for making acceptable corrections involving the transactions listed above. Applicants generally must:

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

Applicants must restore the plan, participants, and beneficiaries to the condition they would have been in had the breach not occurred. The VFCP includes an online calculator to assist applicants by automatically calculating correction amounts that must be paid to the plan. Plans must then file, where necessary, amended returns to reflect corrected transactions or valuations.

Applicants also must provide proof of payment to participants and beneficiaries, or properly segregate the affected assets in cases where the plan is unable to identify the location of missing individuals. Payment of the correction amount may be made directly to the plan where distributions to separated participants would be less than $20 and the cost of correction exceeds the distributions owed.

The Department has adopted an amendment to PTE 2002-51 to expand the relief under the exemption to additional transactions included in the 2006 Update of the VFCP. The class exemption provides relief from certain excise tax provisions of the Internal Revenue Code if the terms of the program and exemption are met.

Prior to the 2006 amendment, the exemption covered most transactions involving:

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

The amended exemption continues to provide excise tax relief for these four transactions, and also provides relief for two additional transactions:

a. Prohibited transaction violations involved in the purchase of an asset by a plan when the asset has been determined to be illiquid, and/or the subsequent sale of the illiquid asset by the plan.
b. Use of plan assets to pay expenses to a service provider for services that are characterized as "settlor expenses," provided such payments were not expressly prohibited in the plan documents.

Additionally, for de minimis situations involving delinquent participant contributions and/or the failure to transmit participant loan repayments, the Department has eliminated the notice requirement.

II. IRS violation relief

The IRS has a correction program referred to as the Employee Plans Compliance Resolution System (EPCRS). Under the EPCRS, plan sponsors have several options for correcting failures. In the event of an operational error, the 403(b) plan has several options for correcting the errors which include self-correction, voluntary correction, and audit closing agreement programs. If a plan sponsor identifies an operational defect and wishes to correct the error on their own in order to preserve the plan's tax status, then this type of correction is referred to as "self-correction." As long as the plan sponsor substantially corrects the error then there is no reporting requirement or fees associated with self-correction. It is important to note that the self-correction option is only available for operational errors.

A voluntary correction program is available for plan sponsors that identify multiple qualification errors. The plan sponsor can pay a fee to the IRS to maintain the tax-exempt status of the plan. However, in order to enter the voluntary correction program, the plan sponsor must identify the error and bring such failure to the attention of the IRS by entering the voluntary correction program before the plan comes under examination. The fee that must be paid by the plan sponsor is based on the size of the plan and is typically much less than the loss of the tax benefit.

If operational errors are identified during an IRS audit and the plan sponsor has not previously brought these errors to the attention of the IRS, then the plan sponsor is eligible to maintain the tax benefits associated with a properly maintained retirement plan. In accordance with the audit closing agreement program ("audit cap"), the plan sponsor will pay a fee based on an amount that is related to the preserved tax benefits. Determination of the fee will take into consideration the nature, extent, and severity of the error, as well as the extent to which the error occurred before the audit.

Therefore, when the plan or plan sponsor is under examination, the plan sponsor:

a. Enters into a closing agreement with the IRS.
b. Effects correction of the failure prior to entering into the closing agreement.
c. Pays a fee that is negotiated with the IRS.

In order to reduce operational and qualification errors, plan auditors should consider assisting their clients in monitoring the plan and help ensure that the plan is operating in accordance with the plan provisions and the rules and regulations of the IRS and the DOL. Below is a sample of items that can be used by the auditor in assisting the plan sponsor with the plan evaluation:

a. Identification of the proper employees to be covered by the plan.
b. Communication with employees regarding their rights and benefits under the plan.
c. Deposits for all employee and employer deferrals were made timely.
d. Compliance with all of the plan provisions.
e. Limiting employee deferrals and employer contributions to the maximum amounts.

If these items are reviewed with the plan sponsor, then the plan auditor can help reduce the risk of plan operational errors.

III. Communications

A. Management representation letter

Plan auditors should obtain certain representations from management that include the assumption of responsibility for the financial statements and supplemental schedules. The representation letter should cover all of the periods presented in the financial statements. Auditors should review the representation letter annually for necessary updates and changes in plan provisions. The representation letter should not be rolled forward from previous years or copied from other engagements. Each representation letter should be able to stand alone for the respective audit. The representation letter should be provided to plan management for their review; after which they will print the letter on the plan sponsor's letterhead and sign the letter.

In addition to the requirements in AU-C Section 580, the auditor should request the following written representations from management in an audit of ERISA plan financial statements:

a. That management has provided the auditor with the most current plan instrument for the audit period, including all plan amendments.
b. Acknowledgement of its responsibility for administering the plan and determining that the plan's transactions that are presented and disclosed in the ERISA plan financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants to determine the benefits due or which may become due to such participants.
c. When management elects to have an ERISA Section 103(a)(3)(C) audit, acknowledgement that management's election of the ERISA Section 103(a)(3)(C) audit does not affect its responsibility for the financial statements and for determining whether:
    (i) An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances;
    (ii) The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8;
    (iii) The certification meets the requirements in 29 CFR 2520.103-5; and
    (iv) The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework

Discussion question:

Who should sign the representation letter? Should you obtain more than one signature?

Most of the time, the plan administrator will be responsible for signing the representation letter. However, if additional individuals provided significant information, guidance, or assistance, then the auditor should request their signature as well.

The management representation letter was historically dated as of the last day of fieldwork. However, due to the issuance of the risk assessment standards, audit opinions and accordingly, management representation letters are now required to reflect the date that the auditor has obtained sufficient evidence to support the opinion rendered and is ready to release the audited financial statements.

B. Legal representation letters

A legal representation letter is generally used only when the client represents that there are no unasserted claims or assessments that are probable of assertion and should be disclosed in accordance with FASB *Accounting Standards Codification* 450, *Contingencies*. Additionally, a legal representation letter may be used to obtain legal representation related to litigation, claims, or assessments for both external and in-house legal counsel.

Typically, the first step that the auditor performs is to inquire of plan management whether or not the plan has consulted an attorney in regard to any current or pending litigation and whether or not they are aware of any unasserted claims or assessments. At this point, the auditor must use their judgment, their knowledge of the plan and history with plan management, as well as other risks associated with the plan to determine the necessity of sending a formal request for representation from the plan's legal counsel.

The legal representation letter should request the following information:

a. A description of all material litigation, claims, and assessments (excluding unasserted claims and assessments) including, but not limited to, litigation relating to:
   (i) Breach of fiduciary responsibilities;
   (ii) Party-in-interest transactions and other transactions prohibited by ERISA;
   (iii) Loans or leases in default and reportable to the Department of Labor;
   (iv) Events reportable to the Pension Benefit Guarantee Corporation;
   (v) Events that may jeopardize the plan's tax qualification status;
   (vi) Legal actions brought against the Plan on behalf of plan participants and beneficiaries; and
   (vii) Review or inquiry by the Department of Labor, the Internal Revenue Service, or other regulatory agency of the plan's activities or filings since the last audit.

b. A description of the nature, progress, management responses, and expected outcome.

c. Identification of any pending or threatened litigation, claims, or assessments.

If the plan auditor determines that it is not considered necessary to request formal representations from legal counsel, then alternative procedures should be performed. For example, the auditor should obtain copies of legal invoices paid by the plan and/or the plan sponsor. The invoices should be examined to determine date and nature of service as well as the amount of the charges. After the auditor has completed the examination of legal invoices, then the auditor should include a representation from plan management in the plan's management representation letter that states the following:

> "We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Statement of Financial Accounting Standards No. 5, and the plan has not consulted a lawyer concerning litigation, claims, or assessments."

C. Evaluation, documentation, and communication with those charged with governance

When the audit work performed results in the identification of items that are not in accordance with the criteria specified (for example, not in accordance with the plan instrument), the auditor should evaluate whether the matters are reportable findings. Reportable findings are matters that are one or more of the following:

a. An identified instance of noncompliance or suspected noncompliance with laws or regulations in accordance with AU-C Section 250;
b. A finding arising from the audit that is, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process in accordance with AU-C Section 260; and
c. An indication of deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention in accordance with AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit.*

The auditor should prepare audit documentation in accordance with AU-C Section 230, *Audit Documentation*. If the auditor has determined that it is not necessary to test any relevant plan provisions, the auditor should document the considerations in reaching such conclusion.

The auditor should communicate in writing to those charged with governance, on a timely basis, reportable findings from the audit procedures performed relating to the matters included in paragraph 20. Such communication should be included with the required communication with those charged with governance in accordance with AU-C Sections 250, 260, or 265, as appropriate, either in a separate section or placed in such communications as the auditor deems appropriate. The written communication should include the following:

a. A description of the reportable finding;
b. Sufficient information to enable those charged with governance and management to understand the context of the communication; and
c. An explanation of the potential effects of the reportable findings on the financial statements or to the plan.

The auditor should not issue a written communication stating that no reportable findings were identified during the audit.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

a. **Significant deficiencies** – 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.
b. **Material weaknesses** – A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility (as defined by professional literature) that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

Examples of circumstances that may be significant deficiencies or material weaknesses include, but are not limited to, the following:

a. Inadequate design of controls over a significant account or process or in the preparation of the financial statements.
   - (i) Improper valuation of investments, especially alternative investments.
   - (ii) Lack of controls over plan mergers and spin-offs, plan terminations, and liquidation accounting.
   - (iii) Lack of controls over accounting for plan amendments.
   - (iv) Lack of controls when changing service providers and ensuring proper information has been transferred to the new service provider.
   - (v) Failure to properly present and disclose investments (such as securities lending activities, master trusts, and alternative investments).
   - (vi) Inappropriate accounting and disclosure for allocated and unallocated contracts. Insufficient control consciousness within the organization.
   - (vii) Plan sponsor has outsourced the administrative functions of the plan with no oversight by management, including not obtaining and reviewing a service organization's report on internal control, if available.
   - (viii) Investing in alternative or complex investments without proper due diligence or consideration for the accounting, reporting, or regulatory requirements.
   - (ix) Lack of performance of tax compliance testing such as discrimination testing or lack of taking appropriate corrective action when errors are found in such testing.
   - (x) For multiemployer plans, improper monitoring of cash received from contributing employers.

If the auditor issues a written communication regarding internal control related matters identified in an audit of your plan, the following items should be included:

a. A statement that indicates the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the plan's internal control.
b. A statement that indicates that the auditor is not expressing an opinion on the effectiveness of internal control.
c. A statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
d. The definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
e. Identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
f. A statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

D. Communication with those charged with governance

Auditors are required to communicate with those charged with governance in accordance with AU 380 (AU-C 260), *The Auditor's Communication With Those Charged With Governance*. Unfortunately, many plans do not have a designated body or person that has been formally charged with the responsibility of plan governance.

The person(s) with responsibility for overseeing the strategic direction of the plan and obligations related to the accountability of the plan may be designated as the individual(s) charged with governance. For example, in a single-employer benefit plan, persons charged with governance may include the audit committee of the plan sponsor or the appropriate group overseeing the financial reporting process of the plan, such as the employee benefit committee, administrative committee, plan administrator, or responsible party.

The required communications include information about the responsibilities of the auditor in regard to the financial statement audit, an overview of the scope and timing of the audit, and any matters that occur during the audit that would be relevant to the persons charged with governance in overseeing the financial reporting process. The items listed below indicate when certain inquiries and communications should be performed.

a. **Beginning of the audit** (See Chapter 2 for additional information on communication at beginning of audit):
   (i) The auditor's responsibility under generally accepted auditing standards (GAAS).
   (ii) The planned scope and timing of the audit.

b. **During the audit:**
   (i) Significant findings and issues from the audit.
   (ii) Difficulties or disagreements with management and/or third-party providers.

c. **End of the audit:**
   (i) Significant findings and issues from the audit.
   (ii) Any management letter comments.
   (iii) Communications about internal control related matters.
   (iv) Uncorrected misstatements to the financial statements.
   (v) Material audit adjustments to the financial statements.
   (vi) Significant issues that were discussed with management.

IV. Supplemental schedules

Form 5500 requires certain supplemental schedules to be prepared and attached to filing based on the plan's activity during the year. Information included in the supplemental schedules is typically provided by the trustee or custodian and the schedule itself may be prepared by the plan administrator. However, preparation of the supplemental schedules by the plan auditor is beyond the scope of the audit. The DOL has prescribed certain formats that must be utilized in the preparation of the supplemental schedules. If the designated format is not followed, then the DOL may reject the Form 5500 filing.

The following are the required supplemental schedules that may be necessary depending on the circumstances for each audit:

a. Schedule G Part I – Schedule of loans or fixed income obligations in default;
b. Schedule G Part II – Schedule of leases in default;
c. Schedule G Part III – Schedule of nonexempt transactions;
d. Schedule H Line 4a – Schedule of Delinquent Contributions;
e. Schedule H Line 4i – Schedule of Assets Held for Investments Purposes at the end of the plan year;
f. Schedule H Line 4i – Schedule of Assets Acquired and Disposed of during the Year; and
g. Schedule H Line 4j – Schedule of Reportable Transactions.

The required format for the supplemental schedules is a tabular format such as the ones listed below.

Schedule of Assets (Held at the End of the Plan Year)

AS OF DECEMBER 31, 20X5 — EIN: 01-0000000 – PLAN NUMBER: 005

(a) Party-in-Interest	(b) Identity of issuer, borrower, lessor or similar party	(c) Description of investment including maturity date, rate of interest, collateral, par or maturity value	(e) Current Value

Schedule H, Line 4J – Schedule of Reportable Transactions

AS OF DECEMBER 31, 20X5 — EIN: 01-0000000 – PLAN NUMBER: 005

(a) Identity of Issuer, Borrower, Lessor, or Similar Party	(b) Description of Investment Including Maturity Date, Rate of Interest, Collateral, Par or Maturity Value	(c) Purchase Price	(d) Selling Price	(e) Lease Rental	(f) Expense Incurred with Transaction	(g) Cost	(h) Current Value	(i) Net gain or Loss

Please note that there are exempt transactions that are not reported on the schedule of reportable transactions, such as participant directed transactions. However, if there is a change in trustees or custodians and the investments equal 5 percent or more of total net assets, then the reportable transaction schedule may be triggered.

Schedule H, Line 4A – Schedule of Delinquent Contributions

DECEMBER 31, 20X5				EIN: XX-XXXXXXX – PLAN NUMBER: 001
	Total that Constitute Nonexempt Prohibited Transactions			
Participant Contributions Late to Plan				
Check here if Late Participant Loan Repayments are included	Contributions Not Corrected	Contributions Corrected Outside VFCP	Contributions Pending Corrections in VFCP	Total Fully Corrected Under VFCP & PTE 2002-51