

Advanced Audits of 401(k) Plans: Best Practices and Current Developments

AAFP/26/V1

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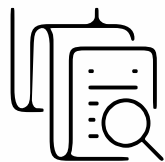
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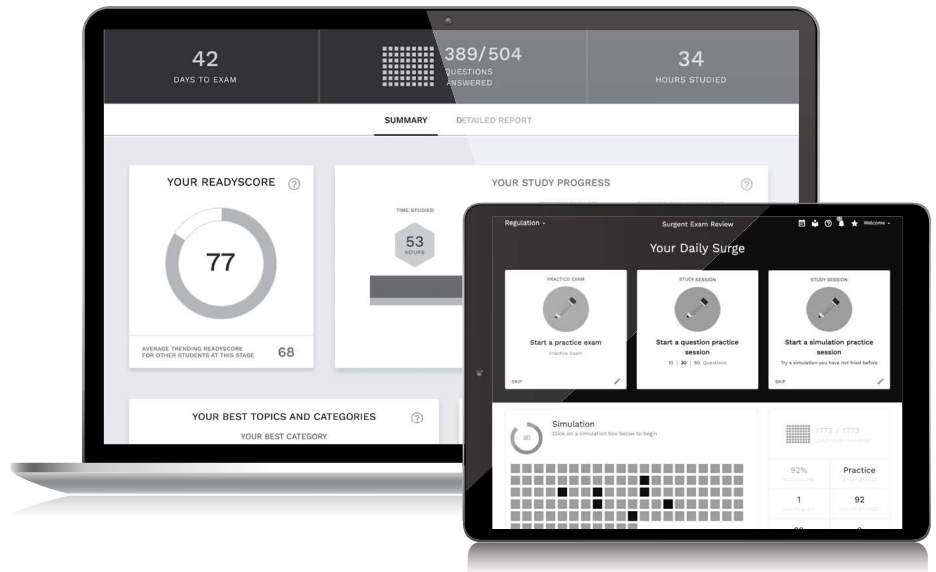
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Overview, Introduction, and Current Year Updates for Employee Benefit Plans

Learning objectives

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

- Understand the history of 401(k) plans and the issues that have arisen along the way;
- Identify the Department of Labor and Internal Revenue Service concerns regarding plan audits;
- Identify the current year updates and changes to rules and regulations impacting employee benefit plans; and
- Describe the common issues identified by the Department of Labor and peer reviewers related to 401(k) plans.

I. Background and history of 401(k) plans

The history and background information for various types of defined contribution plans is explained throughout this chapter in order to provide auditors a starting point when dealing with complex auditing issues that may arise.

An employee benefit plan (EBP) is a benefit other than salary granted by an employer to its employees. In 1974, the Congress of the United States of America passed a federal law, Employee Retirement Income Security Act of 1974 (ERISA), that codified the standards for employers that offer employee benefit plans to their employees. The primary purpose of ERISA is to protect the interests of workers who participate in employee benefit plans and their beneficiaries. ERISA provides for deferral government oversight of the operating and reporting practices of employee benefit plans. Accordingly, ERISA requires employee benefit plan sponsors to prepare and file various documents with the Department of Labor (DOL) and Internal Revenue Service (IRS). ERISA is administered by the Employee Benefit Security Administration (EBSA) of the DOL.

- Title 1 of ERISA contains rules for reporting and disclosure, vesting, participation, funding, fiduciary conduct, and civil enforcement.
- Title II is where the tax law requirements for employee benefit plans are located.
- Title III deals with specific jurisdiction and enforcement procedures, which are beyond the scope of this course.
- Title IV is applicable for multiemployer benefit plans.

Most employee benefit plans are required to file an annual report that also satisfies the annual reporting requirements of Title 1 and IV of ERISA and the Internal Revenue Code (IRC). The annual report that most plans file is Form 5500, "Annual Return/Report of Employee Benefit Plans." Form 5500 is a joint-agency form of the DOL, IRS, and PBGC.

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

ERISA requires plans to provide participants with plan information including important information about plan features and funding; sets minimum standards for participation, vesting, benefit accrual and funding; provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; gives participants the right to sue for benefits and breaches of fiduciary duty.

In general, ERISA does not cover retirement plans established or maintained by governmental entities, churches for their employees, or plans which are maintained solely to comply with applicable workers compensation, unemployment, or disability laws. ERISA also does not cover plans maintained outside the United States primarily for the benefit of nonresident aliens or unfunded excess benefit plans.

Following is a brief summary of the changes affecting 401(k) plans over the years:

- In 1981, the IRS issued rules that allowed employees to contribute to their 401(k) plans through salary reductions, which jumpstarted the widespread rollout of 401(k) plans.
- In 1990, 401(k) plans had more than \$334 billion in assets and more than 19 million active participants.
- By 1996, 401(k) plan assets were more than \$1 trillion with more than 30 million active participants.
- In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRA) **resulted in several changes to the 401(k)**. In general, the law increased the amount that individuals and companies could contribute to the accounts. Additionally, it allowed participants over the age of 50 to make catch-up contributions.
- In 2006, the Pension Protection Act (PPA) made it easier for companies to enroll employees automatically in 401(k) plans.
- From the 2022 Form 5500 database, there are more than:
 - 98,147 plans subject to audit;
 - 151.5 million participants;
 - \$10 trillion in assets subject to audit; and
 - 3,805 CPA firms performing audits.
- There have been five previous audit quality studies:
 - 1989 (23 percent of audits had deficiencies);
 - 1997 (19 percent of audits had deficiencies);
 - 2004 (33 percent of audits had deficiencies);
 - 2015 (39 percent of audits had deficiencies); and.
 - 2023 (30 percent of audits had deficiencies).
- The most recent audit quality study was started in 2021 based on Form 5500 filings from the 2020 plan year. The results of this most recent study will be discussed below.

Defined contribution (DC) plans have grown in popularity since the inception of ERISA. DC plans have become the key source of savings for retirement for most workers in the United States of America. With the increase in assets held in DC plans, comes an increase in investments options, features, and the use of technology to administer the plans. The days of straightforward DC plans are long gone. Today's DC plan auditor must be familiar with things like investment valuation, brokerage accounts, automatic enrollment, and revenue sharing.

II. Current year updates and changes

A. SECURE 2.0 Act

On December 29, 2022, President Biden signed the Consolidated Appropriations Act, 2023 (CAA 2023) into law. The CAA 2023 includes the package of retirement provisions described 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, enabling them to accumulate more assets, and connecting them with those assets when they retire.

B. 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), are as follows:

- **Increased required minimum distribution (RMD) age:** Building on the SECURE Act's increased RMD age of 72, SECURE 2.0 increases the RMD age to 73 beginning in 2023 and then again to 75 in 2033. (In addition, penalties for those who fail to take their RMDs will be reduced.) What does this mean? Anyone who turns 72 in 2023 is not required to take RMDs in 2023; instead, they will be required to start taking RMDs in calendar year 2024, the year they turn 73.
- **Roth catch-up contributions:** 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 §603 of the SECURE 2.0 Act that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions.
- **Expanded eligibility to long-term, part-time workers:** The long-term, part-time worker eligibility provision that was first added by the SECURE Act changes so participation in a DC plan would be attained after just two consecutive years of 500 or more hours (instead of three years, as outlined in 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. (For example, if you have between 500 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 with 500 to 1,000 hours to obtain eligibility.)
- **Mandatory cash-out limits:** The limit for mandatory cash-outs, which last changed in 1997, rises from \$5,000 to \$7,000 (without any indexation in future years).
- **Emergency withdrawal expenses:** An exception from the 10 percent tax is provided for emergency expenses, which are defined as certain unforeseeable or immediate financial needs, on a limited basis (once per year up to \$1,000). However, there is a three-year optional payback period – participants are restricted from taking another emergency withdrawal within three years of any unpaid amount on a previous withdrawal.
- **Required auto-enrollment for new DC plans:** Almost all new DC plans will be required to auto-enroll employees upon hire. (Existing DC plans will be exempt.) This provision is applicable for plan years beginning on or after January 1, 2025.

- **Required annual paper benefit statement:** Plan sponsors relying on the DOL's 2020 e-delivery regulations will be required to provide a paper benefit statement at least once annually for defined contribution plans and at least once every three years for defined benefit plans unless a participant elects otherwise. This provision will be applicable for plan years beginning on or after January 1, 2026.

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

- **Student debt retirement benefit:** Student loan payments may be treated as elective deferrals for the purposes of matching contributions to a retirement plan. This provision will be available for plan years beginning on or after January 1, 2024.
- **Emergency savings accounts:** For plan years beginning on or after January 1, 2024, employers will have the option to offer emergency savings accounts within a retirement plan to non-highly compensated employees. Contributions to these savings accounts will be made post-tax (Roth), and the accounts are capped at \$2,500 (or less, if the employer chooses).
- **Additional catch-up contribution opportunities:** For participants who reach ages 60 through 63 within the taxable year, the catch-up contribution limit increases to the greater of \$10,000 or 50 percent more than the "regular" catch-up amount. This provision will be available for plan years beginning on or after January 1, 2025.
- **Roth matching and non-elective contributions:** If desired, employers can permit employees to elect to treat some or all of their matching and/or non-elective contributions as Roth contributions.
- **Recouping overpayments:** Plan sponsors may choose not to recoup overpayments if retirees mistakenly received too much from their retirement plans; however, restrictions apply to plan sponsors who do choose to recoup overpayments.
- **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.
- **Automatic portability:** A retirement plan service provider is 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. This provision is effective for transactions occurring on or after 12 months after the date of enactment of SECURE 2.0.
- **Domestic abuse withdrawals:** In cases of domestic abuse situations, certain penalty-free withdrawals will be permitted. This provision will be available for plan years beginning on or after January 1, 2024.

Other provisions of note:

- **Lost and found database:** An online federal lost and found database for retirement accounts will be created and maintained by the DOL to help participants find lost retirement benefits. The database will be established within two years of the enactment of the Act.
- **Expanded self-correction of plan violations:** Effective as of the date of enactment, all inadvertent plan violations can be self-corrected under the IRS's Employee Plans Compliance Resolution System (EPCRS) without a submission to the IRS.

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

III. Statements on Auditing Standards and other updates

A. SAS No. 145

In October 2021, the ASB issued SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

SAS No. 145 supersedes SAS No. 122 as amended, AU-C §315 of the same title, and amends various AU-C sections in the 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 §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:

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

- A revised definition of significant risk;
- Revised requirements to evaluate the design of certain controls within the control activities component (including general information technology controls) and to determine whether such controls have been implemented;
- A new requirement to separately assess inherent risk and control risk;
- 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;
- 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;
- Revised requirements relating to audit documentation;
- New guidance on scalability; and
- 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 AU-C §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:

- 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;
- Highlighting the benefits of maintaining professional skepticism during the required engagement team discussion; and
- 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 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.
- 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):

1. The control environment;
2. The entity's risk assessment process;
3. The entity's process to monitor the system of internal control;
4. The information system and communication; and
5. 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:

- 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.
- The use of the term *controls* has been clarified by including the following definition in the standard:
 - “Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context:
 - i. 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.
 - ii. 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:

- Controls over journal entries and other adjustments as required by AU-C §240, *Consideration of Fraud in a Financial Statement Audit*;
- 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
- 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 §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 §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 §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 §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 §240 and AU-C §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 §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 §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 §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 No. 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 §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, as well as 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]).

Among other things, SAS No. 149 does the following:

- Provides a risk-based approach to planning and performing a group audit;
- Introduces the term *referred-to auditor* and revises the definition of the term *component auditor*;
- Addresses special considerations that apply to a group audit, including circumstances in which component auditors are involved or when the group auditor makes reference to the audit of a referred-to auditor; and
- Aligns AU-C §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 No. 149 do not specifically scope out employee benefit plans. However, in most cases, the provisions of SAS No. 149 will not be applicable to employee benefit plans except in very limited circumstances.

C. Other updates

1. New FinREC recommendations

New FinREC recommendations include:

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

2. Revenue sharing

Revenue sharing:

- Revenue sharing amounts not considered ASC 606 revenue:
 - Intended to reduce administrative costs; and
 - Not paid for delivering or producing goods, rendering services, or undertaking other activities for investment manager.
- Consider all relevant facts and circumstances, including terms of agreement, to determine appropriate presentation; and
- FinREC believes:
 - Presentation in plan financial statements should be applied on a consistent basis; and
 - 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.

3. Illustrative tax status

Illustrative tax status:

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

4. ERISA §103(a)(3)(c)

FinREC believes financial statement notes should include:

- 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; and
- The name of the qualified institution that certified the information.

5. 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; and (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*:

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

IV. DOL update

Based on the DOL's 2023 Form 5500 database, there were:

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

Information about the 2,933 firms:

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

The DOL is adding a self-correction component to its Voluntary Fiduciary Correction Program (VFCP) that expands types of transactions covered under VFCP and simplifies the administrative tasks necessary to receive relief.

- 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:
 - Compute lost earnings on the delinquent payments using the online calculator;
 - Remit delinquent payments to the plan within 180 calendar days;
 - Pay any penalties, late fees, and other charges themselves; and
 - Ensure neither the self-corrector nor the plan is "under investigation," as defined by the VFCP.
- Self-correctors must:
 - Notify EBSA of the self-correction by submitting the SCC Notice with the required information through EBSA's web tool; and

- 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.
- Unlike the VFCEP application process, self-correctors will receive an email acknowledgment instead of a “no action” letter.
- Self-correction of eligible inadvertent participant loan failures:
 - The SCC Retention Record Checklist is not required for correction of this transaction.
- Other improvements in 2025 VFCEP Update.

V. Conclusion

The purpose of this history and overview is to provide auditors with the background necessary to address the complex issues and updates associated with auditing defined contribution employee benefit plans.

Understanding 401(k) Plan Unique Attributes

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Understanding 401(k) Plan Unique Attributes

Learning objectives

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

- Evaluate the various types of plan documents;
- Differentiate between the types of plan sponsors and the unique audit considerations;
- Analyze the types of 401(k) plans and their numerous provisions;
- Understand the bonding requirements for a 401(k) plan; and
- Identify parties in interest.

I. 401(k) plans

Due to the fact that employee benefit plan audits are considered to be a specialized knowledge area, auditors should have the appropriate background and experience in order to fully understand the complex rules and regulations governing benefit plans. Let's begin with a simple definition of a 401(k) plan.

A 401(k) plan is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on a pretax or post-tax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees. A profit-sharing feature may also be added to the plan. Earnings on the employee and employer contributions accrue on a tax-deferred basis. The employee is not taxed until the time of distribution.

Employers that establish a 401(k) plan should understand that there are two tax advantages of sponsoring a 401(k) plan. These advantages include the following:

- Employer contributions are deductible on the employer's federal income tax return to the extent that the contributions do not exceed the limitations described in §404 of the Internal Revenue Code (IRC). Refer to Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans), for more information about deduction limitations.
- Elective deferrals and investment gains are not currently taxed and enjoy tax deferral until distribution.

II. Plan instruments

In order to properly design the overall audit, 401(k) plan auditors should have a thorough understanding of the plan instruments. All plans subject to ERISA are required to be in writing. These plan instruments include the plan documents and amendments. The plan instruments normally define the detailed plan provisions such as:

- Eligibility to participate;
- Entitlement to benefits;
- Funding;
- Operation and administration of plan provisions;
- Identification of the plan's named fiduciary and allocation of responsibilities among those who serve in the capacity as fiduciaries for control and management of the plan; and
- Delegation by fiduciaries of duties in connection with administration of the plan.

A qualified plan must satisfy the IRC in both form and operation. That means that the provisions in the plan document must satisfy the requirements of the Code and that those plan provisions must be followed. The IRS administers a determination letter program only to Providers or Mass Submitters that enables plan sponsors to get advance assurance as to the form of their retirement plan document. A “Provider” is any person (including, if applicable, a Mass Submitter) that (1) has an established place of business in the United States where it is accessible during every business day, and (2) represents to the IRS in its application for an Opinion Letter that it has at least 15 employer-clients, each of which is reasonably expected to adopt the same Pre-Approved Plan of the Provider. A “Mass Submitter” is any person that (1) has an established place of business in the United States where it is accessible during every business day and (2) submits Opinion Letter applications on behalf of at least 30 unaffiliated Providers, each of which is offering, on a word-for-word identical basis, the same plan. A flexible plan that is offered by a Provider will be considered a word-for-word identical plan. Employers should establish practices and procedures to ensure the plan is operated in accordance with the plan document, so participants and beneficiaries receive their proper retirement benefits. Be aware that the law and regulations in the retirement plans area frequently change.

Discussion question:

What are some of the common plan instruments associated with 401(k) plans?

The design of an employee benefit plan may take many forms. These forms were previously referred to as: individually designed plans, prototype plans and volume submitter plans. However, with the issuance of Revenue Procedure 2017-41 on June 30, 2017, the prior terminology of Master & Prototype (M&P), and Volume Submitter (VS) plans have been eliminated and replaced with the single term of Pre-Approved Plan. A pre-approved plan can either be of the standardized type or of the non-standardized type. Providers who sponsor a pre-approved plan will receive “opinion letters” evidencing IRS pre-approval, and the term “advisory letter” is eliminated.

This revenue procedure also modifies the on-cycle submission period for the third six-year remedial amendment cycle for Providers of pre-approved defined contribution plans so that it begins on October 2, 2017, and ends on October 1, 2018. Revenue Procedure 2018-42 modifies Revenue Procedure 2017-41 to extend the deadline for submitting on-cycle applications for opinion letters for pre-approved defined contribution plans for the third six-year remedial amendment cycle from October 1, 2018, to December 31, 2018.

This revenue procedure modifies the IRS’s historic approach to pre-approved plans in order to expand the Provider market and encourage employers that currently maintain individually designed plans to convert to the pre-approved format.

The program is simplified by eliminating the distinction between M&P and VS plans. The program is liberalized by increasing the types of plans eligible for pre-approved status. The program is revised to afford greater flexibility in the design of pre-approved plans.

The different types of plan instruments that are available to plan sponsors currently include the following.

A. Individually designed plans

An individually designed plan is meant to be specific to a plan sponsor and will vary from plan sponsor to plan sponsor.

B. Standardized pre-approved plan

The provisions of this type of pre-approved plan must be safe harbor. This generally means the employer will have fewer choices over the design of the plan. The employer must not make any modifications to the plan and can rely on the opinion letter issued to the pre-approved plan as if it were its own determination letter.

Note:

Standardized plans severely limit the design choices of the plan sponsor. For example, all members of a controlled group of employees are required to be covered by the plan. As such, compliance errors may readily arise when an enterprise acquires a company that uses a standardized plan.

The format of a pre-approved plan can either be an adoption agreement plan or a single document plan. An adoption agreement plan consists of a basic plan document and an adoption agreement. The basic plan document consists of all the non-elective provisions and thus cannot include any options or blanks for completion by the employer. The adoption agreement contains the options (and blanks) for completion by the employer and is also where the employer signs the plan. A single document plan does not use an adoption agreement, and its options and alternative paragraphs available for selection by the employer are contained throughout the single document.

The trust or custodial account document associated with either format must be a separate document. In other words, it must be in a document separate from the rest of the plan. The trust or custodial account document must also not be submitted to the IRS for pre-approval. For this reason, each pre-approved plan must contain a statement that the provisions of the plan override any conflicting provision contained in the trust or custodial account document used with the plan.

C. Nonstandardized pre-approved plan

The provisions of this type of pre-approved plan do not have to be safe harbor. The employer is permitted to make minor modifications to the plan. The extent of an employer's ability to rely on the opinion letter issued to the pre-approved plan as if it were its own determination letter will depend upon how many of the plan provisions are safe harbor and if the employer has made any minor modifications to the plan. For example, any minor modification made by the employer to the plan will result in a loss of all reliance on the opinion letter; however, assuming the modification is in fact minor, the employer can obtain reliance by filing for its own determination letter using the Form 5307.

A "mass submitter" of a pre-approved plan is a U.S. business that submits opinion letter applications on behalf of at least 30 unaffiliated providers that have "word-for-word identical" plans to the mass submitter's pre-approved plan.

Even though there is no requirement for a retirement plan to receive an individual determination letter to claim tax-exempt status, determination letters may provide evidence that the plan, at the time of issuance of the determination letter, was designed in accordance with applicable IRC requirements. However, the existence of a favorable determination letter does not, in and of itself, serve as evidence that the plan is qualified. With limited exceptions, determination letters will only be issued covering the formation of a new retirement plan or the termination of an existing retirement plan. Existing determination letters will not expire, and the plan sponsor is required to make amendments as required by changes in the law or plan designs.

Currently, auditors must understand the type of plan that the plan sponsor has formally adopted in order to properly design audit procedures to determine that the plan is operating in accordance with plan provisions.

All tax-exempt plans must comply with certain compliance requirements to retain their tax-exempt status and, when required, amend the plan for changes in regulations. The types of compliance requirements will depend on the type of plan and are often described in the plan document. Regardless of the type of plan, the auditor should be aware of the possibility that violations of tax laws and regulations may have occurred as well as the potential consequences of such violations.

Plan auditors should be prepared to document that they have obtained a copy of the plan document in its entirety, including amendments, and that they obtained an understanding of the applicable plan provisions. The understanding of plan provisions can be documented in a variety of formats including a memo, checklist, or audit program.

All plan documents must be formally amended and updated for the SECURE Act and CARES Act by December 31, 2025, for the provisions that were adopted and/or made available to the participants.

III. Types of 401(k) plan sponsors

Depending on the plan sponsor, a 401(k) plan will be categorized as one of the following: a single employer plan, multiemployer plan, or a multiple-employer plan. The auditor should understand the difference between these categorizations because there are audit procedures unique to each type, which will be explored further in later chapters.

A. Single employer plan

An employee benefit plan sponsored by a single employer or a controlled group of corporations.

1. Controlled groups

In this section, we are going to define and explore controlled groups and their impact on the audit of a defined contribution plan.

A controlled group of companies is defined as overlapping ownership in two or more companies. There are two kinds of controlled groups:

1. A parent-subsidiary controlled group; and
2. A brother-sister controlled group.

A parent-subsidiary controlled group exists when one company owns 80 percent or more of a subsidiary. A brother-sister controlled group exists when five or fewer individuals own 80 percent or more of two or more companies. In certain cases, ownership by a spouse, parent, child, or grandchild may be combined to determine whether a controlled group exists.

2. Implications of a controlled group

The companies that are members of a controlled group may be tested separately if they pass minimum coverage tests (IRC §410[b] test for plan qualification) individually. However, if they do not pass minimum coverage tests, controlled groups must then be tested together. Mandatory contributions will be required if a company fails to offer plan benefits to part of a controlled group and does not pass the required tests.

The employees who were excluded from the benefits of the plan will be paid these mandatory contributions.

Auditors should determine whether or not the plan is sponsored by a single employer or a controlled group of companies because of the impact on the audit engagement. With a controlled group of companies, the auditor will need to obtain information from each employer regarding plan operation and administration, internal controls, fiduciary responsibilities, and other necessary information. Furthermore, the employees from each company will need to be included in all appropriate testing. The additional employers will increase the time spent on the audit.

B. Multiemployer plans

Multiemployer plans cover employees from more than one employer. A collectively bargained plan is maintained by more than one employer, usually within the same or related industries, and a labor union. These plans are often referred to as “Taft-Hartley plans.” A Taft-Hartley multiemployer pension plan is characterized by provisions allowing individual employees to gain credits toward pension benefits from work with multiple employers, as long as each employer has a collective bargaining agreement requiring plan contributions. Often, many employers in the same industry in a geographic area contribute toward the same multiemployer plan. Thus, individual workers moving from job to job continue to earn credits toward future pension benefits.

A multiemployer pension plan is established by negotiating an employer contribution as part of a labor-management agreement and establishing a trust fund. Then, labor organizations bargain with additional employers to have workers covered by these plans.

Most multiemployer plans are jointly administered and governed by a board of trustees, with labor and management equally represented. Members of the board of trustees are either elected or appointed to their position. The selection process for the management trustees usually involves the contributing employers or an association to which they belong, whereas the union determines how the labor trustees are selected. Regardless of who elects or appoints a trustee, the trustee is required to act in the sole and exclusive interest of the plan and its participants.

The plan benefits in a multiemployer plan are determined by the board of trustees. A contribution rate is negotiated by the bargaining parties then translated into a benefit by the trustees. Furthermore, the board of trustees makes the decisions to increase benefits or change the plan. There are some industries such as the mining industry and some segments of the trucking industry that utilize collective bargaining to fix benefit levels. Collective bargaining is a process of negotiation between employers and a group of employees aimed at reaching agreements that regulate working conditions. The collective agreement serves as a labor contract between an employer and one or more unions.

The costs associated with the administration of a multiemployer plan are paid from plan assets.

Multiemployer plans may be either defined contribution or defined benefit plans. While multiemployer 401(k) plans are increasing in popularity, only defined benefit multiemployer plans are covered by Title IV of ERISA and the PBGC, according to 4.72.14.2.2 (05-04-2001) of the IRS. Multiemployer plans are subject to many of the same vesting, accrual, and minimum participation rules that are applicable to single-employer plans; however, there are differences in plan design. Most multiemployer plans are “unit

benefit” plans that offer a specified dollar amount benefit per month multiplied by years of credited service.

In addition, multiemployer plans offer portability – participants retain service if they switch employment from one sponsoring employer to another. Further, many plans in the same industry (for example, trucking) offer reciprocity whereby an employee who moves from one area of the country to another can transfer credit between regional plans.

C. Multiple-employer plan

A multiple employer plan “MEP” (not to be confused with a multiemployer, or Taft Hartley, plan) can be a defined contribution retirement plan established by a plan sponsor who is a single employer, an employee organization (for example, a labor union or an employee beneficiary association), or two or more employers and one or more employee organizations, that is then adopted by additional participating employers. The employers that participate may have a common connection such as an industry association or membership in a cooperative. Another example would be professional employer organizations (PEOs). These types of entities provide a service to allow employers to outsource HR and administrative tasks by offering co-employment or joint employment and have been utilizing the MEP as the underlying plan structure for many years.

In accordance with the previous rules, certain MEPs are treated as a single plan in specified situations, with the result that the plan needs only one Form 5500, one audit, etc., thus resulting in economies of scale for plan sponsors. However, if the plan sponsors are not related, the MEP is treated as a grouping of individual plans, with resulting multiple Form 5500s, audits, etc. Also, to the extent that one plan in the group is deemed to have violated §401(a) rules, the entire plan is at risk for disqualification – the so-called “bad apple rule” under §413(c).

In regard to operational respects, some MEPs function as a single plan. The MEP’s sponsor is responsible for handling the plan-level operations. The participating employers are responsible for funding the contributions solely for their own employees. Each employer is also subject to separate testing under the plan in regard to contributions, distributions, payroll, and the like. However, one of the differences between an MEP and a single employer plan is that certain functions such as the plan audit, Form 5500, and regulatory compliance are all handled at the MEP level instead of by the adopting employer.

Since there is one plan document and only one 5500 annual filing with assets grouped together, there are tremendous savings on the part of a small employer who joins this type of plan since the administration cost is borne by all employers operating under the plan. Furthermore, fiduciary liability is minimized because the plan will be handled by a sponsoring group or association. Since daily 401(k) plan pricing is based on the size of assets, a multiple employer plan offers economies of scale that would generally not be offered to a small employer starting a plan on its own. As a small employer, being a part of an unbundled multiple employer plan is probably more cost effective than the typical standalone plan 401(k) platform.

There is a varying degree of flexibility in plan design features and investments between MEPs.

There must be an “employer.” Both ERISA and the IRC require that the plan be established by an employer or employee organization. The IRS calls this employer the “lead employer” (which we will

sometimes refer to as the “LE” throughout this course). Though the IRC does not actually define the term “employer” for these purposes it is a defined term under ERISA. ERISA defines an employer as “any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.”

There are two ways for a MEP to meet this “LE” requirement:

1. The MEP organizer can actually adopt the plan as an employer in its own right, for its own employees, and open it up for adoption by other employers. This would be the typical “open” model, though it is possible for an association to fall within this model if the plan covers the association’s own employees.
2. A group or association of employers – acting for an employer – to adopt a plan as the “LE.”

In order to be treated as an “employer,” that group or association must meet the so-called commonality requirement. This issue is discussed in further detail below. This would be the common “association” MEP model, where an industry trade group establishes a MEP for its membership under the control of its membership.

The lead employer must have employees. ERISA’s regulations specifically state that the term “employee benefit plan” shall not include “any plan, fund or program, other than an apprenticeship or other training program, under which no employees are participants covered under the plan.”

If the MEP fails to meet the “employer” and “employee” requirement, then the plan is not recognized as a MEP and all participating employers will likely be viewed as maintaining individual plans.

When an employer decides to join an MEP, they adopt the plan document and become a cosponsor along with the other participating employers and the lead employer. The participating employer will sign a joinder agreement which serves in a similar manner to an adoption agreement for a prototype plan document.

For the majority of adopting employers, the investment options are generally the same. The reason is that if individual employers are given discretion when it comes to investment options then there is a transfer of investment oversight back to the adopting employer. This transfer would then weaken the fiduciary benefits of the plan. When it comes to plan features, it is an entirely different story. Plan documents for MEPs may vary with some plans offering only safe harbor or automatic enrollment plan structures. Meanwhile, other MEPs have written their master plan to accommodate a wide variety of provisions, resulting in little or no takeaways for employers merging into the plan. It is imperative to note that all nondiscrimination tax qualification testing remains at the adopter level and that these compliance services will generally be handled by the MEP as part of its overall plan administration package.

As of July 29, 2019, the U.S. Department of Labor announced a new rule that expands access to affordable quality retirement saving options for Americans working in small and mid-sized businesses.

America's workers in small and mid-size businesses have had limited options when it comes to employer-based retirement plans.

- According to a 2018 study by the U.S. Bureau of Labor Statistics, approximately 38 million private-sector employees in the United States do not have access to a retirement savings plan through their employers.
 - Approximately 85 percent of workers at private-sector establishments with 100 or more workers were offered a retirement plan.
 - In contrast, only 53 percent of workers at private-sector establishments with fewer than 100 workers had access to such plans.
- A survey by the Pew Charitable Trusts found that only 53 percent of small to mid-sized businesses offer a retirement plan; 37 percent of those not offering a plan cited cost as a reason.

This new rule will help strengthen retirement security for American workers.

- Multiple Employer Plans (MEPs) are a type of retirement plan that covers employees of more than one employer.
- Under the new rule, small and mid-size businesses will gain access to retirement savings options through Association Retirement Plans (ARPs).

1. Association Retirement Plans (ARPs)

ARPs will help millions of Americans gain new access to these employer-based retirement security options:

- The final rule makes it clear that an ARP can now cover employers not just in the same industry as before, but in the same geographic area, such as a common state, city, county, or a metropolitan area (even if it crosses state lines).
- Working owners without employees, including sole proprietors, can participate. The final rule includes a regulatory safe harbor for PEOs who want to offer retirement options.
- Some PEOs currently offer employee benefit plans to their client employers and now will have clear standards.

ARPs have many possible benefits:

- Expanding access to ARPs will allow small and mid-size businesses to obtain the economies of scale for administrative costs and investment choices currently enjoyed by large employers.
- Participating in an ARP or other MEPs will lower costs and decrease the regulatory burden and fiduciary liability on small and mid-size businesses.

The DOL Final Regulations expand the use of MEPs by providing that bona fide employer groups or associations (Association Retirement Plans or ARPs) and bona fide Professional Employer Organization (PEOs) may act as an 'employer' under ERISA §3(5) for purposes of sponsoring a MEP that is a defined contribution plan. Specifically, with respect to plans of bona fide organizations or employer groups, the DOL Final Regulations provide that plan sponsors in the same industry or in the same area are deemed to have a commonality of interest for MEP purposes.

The DOL Final Regulation will be effective September 30, 2019. The final rule is limited to defined contribution plans and does not cover welfare benefit plans or other types of pension plans.

2. Pooled Employer Plans (PEPs)

The Setting Every Community Up for Retirement Enhancement (SECURE) Act:

The SECURE act created Pooled Employer Plans (PEPs) – a form of “open” Multiple Employer 401(k) Plan (MEP) that any employer can join. MEP supporters claim PEPs will offer two key advantages over traditional single-employer 401(k) plans: lower fees for retirement savers and liability protection for employers;

- a. Economies of scale: Through gathering the 401(k) assets of multiple employers, supporters claim MEPs can offer lower fees and higher quality services to small employers with fewer 401(k) assets due to “economies of scale.” Years of falling prices and “fee compression” has forced many plan providers to lower costs. The MEP provides another channel with some additional benefit.
- b. Reduced fiduciary liability: Employers must meet certain fiduciary responsibilities to protect the interests of their 401(k) plan participants. When employers join a MEP, they delegate many (if not all) of their fiduciary responsibilities to the MEP provider - a Pooled Plan Provider (PPP) in the case of a PEP. This delegation can sound like an easy way for employers to reduce their fiduciary liability until you understand that 401(k) fiduciary responsibilities include a duty to “monitor” plan service providers or ensure they’re doing a competent job for reasonable fees.

The following information on PEPs was obtained from the AICPA Employee Benefit Plan Audit Quality Center:

A PEP is an individual account plan established or maintained for the purpose of providing benefits to the employees of two or more unrelated employers as a qualified retirement plan or a plan funded entirely with individual retirement accounts (IRA plan), the terms of which must meet certain requirements set forth in the SECURE Act. A PEP is a type of multiple employer plan (MEP) that allows unrelated employers to participate in a single, shared defined contribution plan, which is treated as a single plan for purposes of satisfying Employee Retirement Income Security Act of 1974 (ERISA) requirements. A PEP is considered to be an “open MEP” because there are no requirements that participating employers be in the same industry or location (in a “closed MEP,” the employers must share common interests and/or organizational relationships beyond the provision of benefits), nor are there limits to the number of participating employers in a PEP. Each participating employer in a PEP generally selects from a range of plan provisions, as specified in the PEP plan document.

A PEP must have a pooled plan provider (PPP) that is designated by the terms of the plan as a named fiduciary and plan administrator. The PPP performs certain administrative duties, including conducting proper compliance testing with respect to the PEP and the employees of each employer in the PEP. A PPP can be any qualified person, as defined in the SECURE Act, but it is expected that most PPPs will be organizations such as insurance companies, banks, trust companies, consulting firms, record keepers, and third-party administrators. The PPP must register with the Department of Labor.

A PEP must designate one or more trustees to be responsible for collecting contributions to, and holding the assets of, the plan and require such trustees to implement written contribution collection procedures that are reasonable, diligent, and systematic. The PPP is responsible for ensuring that all persons who handle assets of, or who are fiduciaries of, the PEP are bonded. Except with respect to certain administrative duties of the PPP, each participating employer in a PEP is legally treated as a plan sponsor with respect to the portion of the plan attributable to employees of such employer (or beneficiaries of such employees) and retains fiduciary responsibility for the selection and ongoing monitoring of the PPP and any investment and management of plan assets not delegated to another fiduciary by the PPP.

Under §101 of the SECURE Act, a PEP is not treated as failing the IRS qualification requirements solely because a single employer fails to satisfy those requirements as long as the PEP provides for the transfer of the offending employer's plan assets to one of various specified arrangements.

How is a PEP different from other multiple employer plans (MEPs) and other multiemployer plans?

MEPs are maintained by two or more employers for the purpose of pooling investments and sharing administrative costs. MEPs typically maintain separate accounts for each of the employers within the plan and are treated as a single plan under the IRC. However, a MEP may or may not be treated as one plan under ERISA. The DOL has imposed a "common interest" requirement on employers adopting MEPs that must be met if the MEP is to be treated as one plan for ERISA purposes. As noted above, a PEP is a type of open MEP and is not subject to the common interest requirement that applies to other MEPs. As such, PEPs are considered a single plan for both IRS and ERISA purposes.

Multiemployer plans are similar to MEPs in that both types of plans are single plans that cover participants of more than one employer; however, multiemployer plans are subject to the terms of a collective bargaining agreement (CBA) between two or more contributing employers (or a group association of employers) and a labor union. For more information on multiemployer benefit plans, see chapter 9 of the 2021 version of the AICPA Audit and Accounting Guide, Employee Benefit Plans.

What are the DOL financial reporting requirements for a PEP?

Preparers of PEP financial statements presented in accordance with generally accepted accounting principles (GAAP) should follow the accounting guidance in FASB Accounting Standards Codification 962, Defined Contribution Pension Plans. In addition, further implementation guidance can be found in the AICPA Audit and Accounting Guide, Employee Benefit Plans.

The administrator of a PEP must file an annual Form 5500, Annual Returns/Reports of Employee Benefit Plan. In addition, if the DOL's implementing regulations, which were published in the Federal Register on September 15, 2021, are finalized as proposed, the PEP administrator will be required to provide additional information, including a list of employers in the plan, a good faith estimate of the percentage of total contributions made by such employers during the plan year, the aggregate account balances attributable to each employer in the plan, which is determined as the sum of the account balances of the employees of such employer (and the beneficiaries of such employees), and the identifying information for the PPP designated under the terms of the plan as the PPP.

PEPs that meet one of the following requirements may be required to have an annual financial statement audit:

- PEPs that have a participating employer that has 100 participants or more; and/or
- PEPs that have 1,000 participants or more.

IV. Types of available 401(k) plans

There are several types of 401(k) plans available to employers such as traditional 401(k) plans and safe harbor 401(k) plans and there are different rules that apply to each. For tax-favored status, a plan must be operated in accordance with the applicable rules. Therefore, it is important that both the auditor and the employer understand the special rules that apply to plans to make sure that the plan is administered in accordance with those rules. To qualify for the tax benefits available to qualified plans, a plan must contain both the language that meets certain requirements (qualification rules) of the tax law and be operated in accordance with the plan's provisions.

The following is a brief overview of important qualification rules. It is not intended to be all inclusive.

A. Traditional 401(k) plans

A traditional 401(k) plan allows eligible employees to make pretax elective deferrals through payroll deductions. In addition, in a traditional 401(k) plan, employers have the option of:

- Making contributions on behalf of all participants;
- Making matching contributions based on employees' elective deferrals; or
- Both.

These employer contributions may be subject to a vesting schedule which provides that an employee's right to employer contributions becomes non-forfeitable only after a period of time or be immediately vested. Rules relating to traditional 401(k) plans require that contributions made under the plan meet specific nondiscrimination requirements. In order to make sure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees.

B. Safe harbor 401(k) plans

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:

- Employer matching contributions;
- Limited to employees who defer; or
- 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 exempt from the top-heavy rules of IRC §416.

Historically, employers sponsoring safe harbor 401(k) plans were required 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 were required to be provided to each eligible employee for the plan year. The notice had to also satisfy the content and timing requirements. The content requirement requires that the notice describe

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

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

In accordance with the SECURE Act, the 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.

C. Profit-sharing plans

A profit-sharing plan is a 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. The contributions are accounted for each participant separately and can be subject to a vesting schedule. A formula will need to be determined in regard to how the employer contribution will be allocated to each participant. A pure profit-sharing plan only has employer contributions. However, the plan sponsor may elect to create a profit-sharing plan with a 401(k) feature.

There are many reasons why employers create profit-sharing plans, including:

- A well-designed profit-sharing plan can help attract and keep talented employees.
- Contributions to a profit-sharing plan are discretionary. The employer can choose when and how much to contribute.
- This type of plan gives employers flexibility in design of key features.
- A profit-sharing plan benefits a mix of rank-and-file employees and owner or managers.
- The money contributed may grow through investments in stocks, mutual funds, and other investment vehicles.
- Contributions and earnings generally are not taxed by the federal government or by state governments until they are distributed.
- A profit-sharing plan may allow participants to take their benefits with them when they leave the company, easing administrative responsibilities.

The profit-sharing plan has features and operations similar to those of a 401(k) plan in regard to eligibility, employer contributions, vesting, nondiscrimination testing, and fiduciary responsibilities.

Profit-sharing plans are popular tools used by employers to provide benefits to their employees, and the audit and reporting requirements are the same as those for 401(k) plans. Profit-sharing plans are subject to the same constraints and regulations as are most retirement plans. For a successful profit-sharing plan, each of the following five profit-sharing plan functions must be well executed: design, investment, recordkeeping, administration or compliance, communication with employees, and control of expenses.

Mistakes in recordkeeping, administration, and compliance could result in large penalties by the IRS or even plan disqualification. Employers should not assume that the work of a third-party administrator is correct and should review it.

D. Plans with an 11-K filing requirement

If a defined contribution plan offers 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. Form 11-K must be filed for those plans offering employer stock as an investment option. The 1933 Securities Exchange Act exempts plans from registration if employee contributions are not utilized to purchase employer stock. Usually, auditors faced with a plan that may have a Form 11-K filing requirement would encourage the plan sponsor to seek legal counsel's advice as to the filing requirements of the plan. The auditor should not be making these determinations.

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 Public Company Accounting Oversight Board (PCAOB) instead of GAAP. Please note that the DOL will not accept financial statements prepared in accordance with PCAOB and the SEC will not accept financial statements prepared in accordance with GAAP. Therefore, 11-K plans must complete two separate audit reports in order to comply with the different reporting requirements.

Furthermore, 11-K plans can elect to file its financial statements in accordance with either the requirements of the SEC Act of 1934 or ERISA. The SEC Act of 1934 requires the financial statements to be filed within 90 days following the plan's year end. If ERISA-compliant statements are elected, the financial statements are required to be filed within 180 days of the plan's year end. Generally, plan sponsors of these plans have chosen to file financial statements in compliance with ERISA. The SEC will not accept an ERISA limited-scope audit report so the investments and investment-related income must be subjected to full-scope audit procedures.

In order to perform an audit on an 11-K plan, the audit firm must be registered with the PCAOB and adhere to the rules and regulations including those with respect to independence, which are somewhat different from those of the DOL. As a result of registering with the PCAOB, the firm's working papers for 11-K audits are subject to periodic reviews by the PCAOB.

V. Bonding requirements

A fidelity bond required under ERISA §412 specifically insures a plan against losses due to fraud or dishonesty (e.g., theft) on the part of persons (including, but not limited to, plan fiduciaries) who handle plan funds or other property.

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. Fraud or dishonesty includes, but is not limited to, larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication, and other acts. Every fiduciary of an employee benefit plan is required to be bonded in accordance with ERISA §412.

Fidelity bonding is usually necessary for the plan administrator and those officers and employees of the plan or plan sponsor (employer, joint board, or employee organization) who handle plan funds by virtue of their duties relating to the receipt, safekeeping, and disbursement of funds. The bonding requirement is not limited to just plan trustees, employees of the plan and employees of the plan sponsor. Bonding coverage may also be required for other persons, such as service providers to the plan, whose duties involve access to plan funds or decision-making authority that can give rise to a risk of loss through fraud or dishonesty. Where a plan administrator, service provider, or other person who must be bonded is an entity, such as a corporation or association, ERISA's bonding requirements apply to the natural persons or person who "handles" the funds.

Caution:

Plan sponsors often confuse the bonding requirement with their coverage under other insurance policies. Many times, the plan sponsor will provide the auditor with a copy of a detailed insurance policy that includes specific riders for fiduciary coverage, theft, and embezzlement coverage, and even in some cases, ERISA coverage. However, the fidelity bond is a separate agreement from the fiduciary coverage that is provided under the general umbrella policy of a corporate policy.

In a typical bond, the plan is the named insured, and a surety company is the party that provides the bond. The persons "covered" by the bond are the persons who "handle" funds or other property of the plan (i.e., plan officials). The plan whose funds are being handled must be specifically named or otherwise identified on the bond in such a way as to enable the plan's representatives to make a claim under the bond in the event of a loss due to fraud or dishonesty. As the insured party, the plan can make a claim on the bond if a plan official causes a loss to the plan due to fraud or dishonesty.

Bonds must be placed with a surety or reinsurer that is named on the Department of the Treasury's Listing of Approved Sureties, Department Circular 570 (available at fms.treas.gov/c570/c570.html).¹ Under certain conditions, bonds may also be placed with the Underwriters at Lloyds of London.² In addition, neither the plan nor a party in interest with respect to the plan may have any control or significant financial interest, whether direct or indirect, in the surety, or reinsurer, or in an agent or broker through which the bond is obtained.

ERISA §412 requires that the bond insure the plan from the first dollar of loss up to the maximum amount for which the person causing the loss is required to be bonded. Therefore, bonds cannot have deductibles or similar features whereby a portion of the risk required to be covered by the bond is assumed by the plan or transferred to a party that is not an acceptable surety on ERISA bonds.³ 29 C.F.R. § 2580.412-11. However, nothing in ERISA prohibits application of a deductible to coverage in excess of the maximum amount required under ERISA.

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.

Generally, each person must be bonded in an amount equal to at least 10 percent of the amount of funds he or she handled in the preceding year. The bond amount cannot, however, be less than \$1,000, and

¹ 29 C.F.R. §2580.412-21, §2580.412-23, §2580.412-24.

² 29 C.F.R. §2580.412-25, §2580.412.26.

³ 29 C.F.R. §2580.412-11.

the Department cannot require a plan official to be bonded for more than \$500,000, or \$1,000,000 for plans that hold employer securities. These amounts apply for each plan named on a bond.

For example, assume your company's plan has funds totaling \$1,000,000. The plan trustee, named fiduciary, and administrator are three different company employees that each have access to the full \$1 million, and each has the power to transfer plan funds, approve distributions, and sign checks. Under ERISA, each person must be bonded for at least 10 percent of the \$1 million or \$100,000.

The fidelity bond may be applicable to cover several fiduciaries at one time and is generally renewable annually.

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. The appropriate box should also be checked on the Form 5500 if the plan does not have a valid fidelity bond.

For a more detailed discussion of ERISA's fidelity bonding requirements, visit the Employee Benefits Security Administration's website at dol.gov/ebsa/regs/fab2008-4.html to view the Department's Field Assistance Bulletin 2008-04.

VI. Identification of parties in interest

One of the most important areas in a benefit plan audit, regardless of the type of defined contribution plan, includes identifying all of the individuals and other entities associated with the plan. The plan may have contracts with many different service organizations. For example:

- The plan administrator is responsible for the administration of plan assets.
- The custodian or trustee is charged with the safekeeping of plan assets.
- The third-party recordkeeper is responsible for the daily plan administration and transaction processing.
- Additional service organizations may include any or all of the following: insurance company, investment manager, payroll processing service organizations, benefits consultant, certified public accountant, and legal counsel.

It is essential that the auditor obtain a complete listing of all parties associated with the operation of the plan in order to properly understand the client and its environment, identify internal controls, determine the scope of the audit and the timing of the audit engagement, as well as assess the risks associated with the client and the engagement. One of the initial steps in the audit process is to identify the parties responsible for plan operation and administration on a daily and regular basis. Those charged with governance of the plan should be established for purposes of making appropriate communications throughout the engagement process. This can sometimes be a challenging task as the responsibilities for the plan may not have been clearly delineated prior to the plan audit process. The auditor can obtain this information by making inquiries of the plan sponsor, reviewing plan documents, and reviewing service agreements. A list of parties in interest should be maintained by the plan's sponsor as part of their fiduciary responsibilities.

Disqualified person (party in interest). You are a disqualified person if you are any of the following:

1. A fiduciary of the plan.
2. A person providing services to the plan.
3. An employer, any of whose employees are covered by the plan.
4. An employee organization, any of whose members are covered by the plan.
5. Any direct or indirect owner of 50 percent or more of any of the following:
 - a. The combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation that is an employer or employee organization described in (3) or (4).
 - b. The capital interest or profits interest of a partnership that is an employer or employee organization described in (3) or (4).
 - c. The beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in (3) or (4).
6. A member of the family of any individual described in (1), (2), (3), or (5). (A member of a family is the spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.)
7. A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner described in (1) through (5) holds 50 percent or more of any of the following:
 - a. The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.
 - b. The capital interest or profits interest of a partnership.
 - c. The beneficial interest of a trust or estate.
8. An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7).
9. A 10 percent or more (in capital or profits) partner or joint ventures of a person described in (3), (4), (5), or (7).
10. Any disqualified person, as described in (1) through (9) above, who is a disqualified person with respect to any plan to which a §501(c)(22) trust is permitted to make payments under ERISA §4223.

The auditor must be able to identify the parties in interest so that they will be able to determine if the plan has engaged in any prohibited transactions. Examples of parties in interest as noted above include all service providers to the plan (trustee/custodian, recordkeeper, auditor, payroll company, insurance company, ERISA attorney, etc.). Prohibited transactions are transactions between the plan and a disqualified person that are prohibited by law.

Prohibited transactions generally include the following transactions.

- A transfer of plan income or assets to, or use of them by, or for the benefit of, a disqualified person.
- Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest.
- The receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets.
- Any of the following acts between the plan and a disqualified person:
 - Selling, exchanging, or leasing property.
 - Lending money or extending credit.
 - Furnishing goods, services, or facilities.

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

Exemption:

Certain transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if you are a disqualified person and receive any benefit to which you are entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

Prohibited transactions are subject to 15 percent excise tax, must be disclosed in the financial statements and reported on the Schedule of Nonexempt Transactions.

Once the appropriate parties have been identified and discussed by the engagement team, the auditor can continue with the planning of the engagement, documenting their understanding of internal controls and assessing the risk of material misstatement.

Audit Planning, Systems of Internal Control, and Risk Assessment

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Audit Planning, Systems of Internal Control, and Risk Assessment

Learning objectives

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

- Discuss related-party and party-in-interest transactions;
- Understand the importance of audit planning and appropriate documentation;
- Identify the key systems of internal controls associated with an employee benefit plan, including the importance and usefulness of the SOC reports; and
- Understand the risk identification and assessment for a 401(k) plan.

I. Introduction

The material in this chapter provides guidance on the application of GAAS during the planning of an employee benefit plan audit. Specifically, obtaining an understanding of the plan's operations and control environment; assessing and responding to the risk of material misstatement and developing an overall audit strategy.

Planning is a continuous process that is reviewed and updated throughout the engagement.

In accordance with AU-C §200, the purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework which enhances the degree of confidence that intended users place on the financial statements.

As the basis for the auditor's opinion, GAAS requires the auditor to obtain reasonable assurance (a high, but not absolute, level of assurance) about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

Timely planning and documentation of planning decisions is essential. Proper planning allows for early identification of accounting, auditing, and reporting issues, as well as the coordination of client assistance, audit staffing, and engagement timing.

Auditors are responsible for having appropriate competence and capabilities to perform the audit, complying with relevant ethical requirements, and maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit. Factors to be considered include expertise in performing employee benefit plan audits, the ability to meet management's time requirements and deadlines, and the ability to comply with the ERISA audit requirement.

In accordance with SAS No. 136, one of the objectives of the auditor is to accept an ERISA plan audit engagement when the basis upon which it is to be performed has been agreed upon through establishing whether the preconditions for the audit are present.

In addition to the preconditions for an audit in AU-C §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.
- c. When management elects to have an ERISA §103(a)(3)(C) audit, determining whether:
 - i. An ERISA §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.

Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. Paragraph .27 of QC §10 provides that the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only when the firm:

- a. Is competent to perform the engagement and has the capabilities, including time and resources, to do so;
- b. Can comply with legal and relevant ethical requirements; and
- c. Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity. Paragraph .A12 of QC §10 states that matters to consider regarding the integrity of a client include, for example, the identity and business reputation of the client's principal owners, key management, and those charged with governance.

Note:

It should be noted that certain independence requirements applicable to an engagement differ among the AICPA, SEC, PCAOB, and DOL.

Note:

In June 2022, the AICPA's Auditing Standards Board (ASB) and Accounting and Review Services Committee (ARSC) issued four interrelated new quality management standards designed to improve a CPA firm's risk assessment and audit quality.

The new standards are intended to modernize quality control and reflect new realities in practice, such as an increased emphasis on risk assessment, changes in technology, and the growing use of external service providers. The four standards are:

- Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management*;
- SQMS No. 2, *Engagement Quality Reviews*;
- Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*; and
- Statement on Standards for Accounting and Review Services (SSARS) No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*.

Unfortunately, there are still instances where firms will accept an engagement without understanding or obtaining the necessary skills and knowledge to properly perform an audit for an employee benefit plan.

Caution:

If the auditor performs nonattest services, such as preparing the Form 5500 or **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.

ET 1.295 of the AICPA *Code of Professional Conduct* provides guidance on the performance of allowable nonattest services for an attest client. Before performing nonattest services, the practitioner is required to establish and document in writing his or her understanding with the client regarding (1) the objectives of the engagement, (2) the services to be performed, (3) the client's acceptance of its responsibilities, (4) the practitioner's responsibilities, and (5) any limitations of the engagement. ET 1.295 also includes requirements for the practitioner (1) to be satisfied that, among other things, the client agrees to assume all management responsibilities pertaining to the nonattest service and oversee the service by designating an individual who possesses suitable skill, knowledge, and/or experience; (2) to assess and be satisfied that the designated individual understands the services to be performed sufficiently to oversee them; and (3) to consider whether the performance of multiple nonattest services to the client creates a threat to independence.

Auditors need to ensure that they have properly documented their consideration of threats to independence which includes the performance of nonattest services as part of or in addition to the audit engagement.

II. Audit scope

When the term audit scope is mentioned, many auditors automatically assume that the discussion is centered around whether or not the engagement is going to be an ERISA or ERISA §103(a)(3)(C) audit. However, there are many other factors that could impact the scope of the overall engagement.

Paragraph .07 of AU-C §300, *Planning an Audit* (AICPA, *Professional Standards*), states that the auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan. Information about the nature of the employee benefit plan and the scope of the audit is critical in planning the engagement. Examples of matters that could affect the scope of the audit include the following:

- a. Whether the audit will be an ERISA or ERISA §103(a)(3)(C) audit pursuant to the exemption allowed under the DOL's rules and regulations.
- b. Whether there will be any other scope limitations imposed by circumstances or by management, provided the auditor believes the restrictions imposed by management will result in a qualified opinion, or a disclaimer of opinion that is acceptable under the applicable law or to the regulator. (See paragraphs .07 and .A18 of AU-C §210, *Terms of Engagement* [AICPA, *Professional Standards*].)
- c. Involvement of third-party service organizations and other key service providers and, if so, the availability of SOC 1 reports relating to their services.
- d. The type of trust arrangement and nature of investment options.
- e. Whether the certifying institution is a qualified organization under the DOL's rules and regulations.
- f. Whether there were any changes in service providers (for example, trustee, custodian, recordkeeper, claims processor, or actuary).
- g. Whether the audit is an initial audit, a final audit, or an audit of a plan that merges into or spins out of an existing plan.

As an experienced auditor, you should already be familiar with the differences between an ERISA audit and an ERISA §103(a)(3)(c) audit engagement. However, the DOL and many peer reviewers still identify issues related to full- and limited-scope engagements.

The ERISA §103(a)(3)(C) applies **only** to the investment information certified by the qualified certifying institution and **does not** extend to participant data, contributions, benefit payments, required financial statement disclosures, or other information, regardless of whether it is included in the certified information.

In an ERISA §103(a)(3)(C) audit, the investment information certified by the qualified certifying institution includes all of the following at the plan level:

- Purchases and sales of investments;
- Investment income (realized and unrealized); and
- Investment fair value.

Investment activity at the participant level will **ALWAYS** be subject to audit procedures regardless of whether or not there is a certification from a qualified certifying institution. Participant level investment activity includes the participant's ability to change their allocations amongst the various investment options offered by the plan and the investment income allocated to the participant's individual account. Unfortunately, there are still instances where auditors fail to apply procedures to these two participant level areas.

Discussion question:

Assume ABC Bank and Trust Company served as the Plan's trustee for the period from January 1, 20X1 through August 31, 20X2. ABC will provide a certification for the entire period that they held the assets (through August 31, 20X2). The new custodian, XYZ Insurance Company, assumes responsibility for the plan assets for the remainder of 20X2.

1. How would the auditor proceed if XYZ Insurance Company will only provide a certification for the period from September 1, 20X2 through December 31, 20X2?
2. What if XYZ Insurance Company will not provide a certification for any portion of the plan year?
3. How would the auditor proceed if XYZ Insurance Company certified the information for the entire period from January 1, 20X2 through December 31, 20X2?
4. What if the certification for the period September 1, 20X2 through December 31, 20X2 was provided by Plan Recordkeeping Services, Inc. as an agent of XYZ Insurance Company?

A. Communication with those charged with governance

Paragraph .11 of AU-C §260, *The Auditor's Communication With Those Charged With Governance* (AICPA, Professional Standards), states that the auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. In accordance with paragraph .A18 of AU-C §260, care is required when communicating with those charged with governance about the planned scope and timing of the audit, so as not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved in managing the entity.

Those charged with governance may be defined as the person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

For purposes of GAAS, **Management** means the person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner manager.

When the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. This is very often the case with smaller, less formal plan sponsors.

The required communications at the beginning of the audit may be included in the engagement letter or in a separate letter or may even be communicated orally. When matters required to be communicated by this section have been communicated orally, the auditor should include them in the audit documentation, including when and to whom they were communicated.

In accordance with AU-C §260, the auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (SAS No. 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 §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:

- How the auditor plans to address significant risk of material misstatement whether due to fraud or error;
- How the auditor proposes to address areas of higher assessed risk of material misstatement;
- 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;
- 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;
- 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;
- The auditor's approach to internal control relevant to the audit;
- The application of materiality in the context of an audit, as discussed in AU-C §320, *Materiality in Planning and Performing an Audit*;
- 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;
- The views of those charged with governance about the following matters:
 - The appropriate person(s) in the plan's governance structure with whom to communicate;
 - The allocation of responsibilities between those charged with governance and management;
 - The plan's objectives and strategies and the related business risks that may result in material misstatements;
 - Matters those charged with governance consider as warranting particular attention during the audit and any areas for which they request additional procedures to be undertaken;
 - Significant communications between the entity and regulators; and
 - Other matters those charged with governance believe are relevant to the audit of the financial statements.
- 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;
- 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:
 - The relevance, reliability, comparability, and understandability of the information presented in the financial statements.
 - Whether all required information has been included in the financial statements, and whether such information has been appropriately classified, aggregated or disaggregated, and presented.

- The actions of those charged with governance in response to previous communications with the auditor; and
- 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 §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.

III. Audit planning

In accordance with AU-C §300, planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. The objective of the auditor is to plan the audit so that it will be performed in an effective manner. Engagement planning is a continual and iterative process that often begins at the completion of the previous audit and continues until the completion of the current audit engagement.

Factors to consider as the planning process begins:

- Coordination of plan sponsor and plan audits;
- Consideration of payroll and demographic data;
- Internal auditors;
- Location of personnel records;
- Electronic data and reports; and
- Timing of audit procedures and reporting deadlines.

These are just a few examples of some things that auditors will need to consider as they begin to develop their understanding of the plan, its environment, and system of internal controls.

Caution:

Some of the deficiencies noted in regard to planning an employee benefit plan audit include failure to properly document the auditor's understanding of the plan, insufficient documentation related to system of internal controls (at both the plan sponsor and service providers), failure to identify risks related to fraud, and failure to properly link the risk assessment to the audit procedures performed.

A. Understanding the plan and its environment

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.

The auditor should allow sufficient time during the planning in order to:

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

Key elements regarding obtaining an understanding of the plan include consideration of the following:

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

SAS No. 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 §315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. AU-C §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:

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

As a reminder, 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 new explicit requirement to understand the use of IT in the entity's structure, ownership, 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; and
- 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).

ERISA §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. SAS No. 136 requires the auditor to 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.

Auditors can document their understanding of the plan in many different ways. 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.

Documenting the understanding of the plan includes the plan documents and related agreements. In order to properly identify risks and design an overall audit strategy, the auditor should obtain an understanding of the key plan provisions such as:

- Identification of trustee;
- Participant eligibility;
- Types of allowed contributions (employee and employer);
- Definition of compensation;
- Allowable distributions from the plan;
- Participant loans;
- Vesting and forfeiture requirements; and
- Other unique plan attributes.

B. Analytical review procedures used during risk assessment

AU-C §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.

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, changed 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.

Common errors made by auditors include performing the analytical review with a routine, same-as-last-year attitude and failing to document auditor expectations on the analytical procedures.

The analytical procedures can provide the auditor with valuable information related to potential risks of material misstatement when used properly.

C. Systems of internal control considerations

Obtaining an understanding of the entity (for example, the employee benefit plan) and its environment, including the entity's systems of internal control, is a continuous process of gathering, updating, and analyzing information throughout the audit. Paragraph .A3 of AU-C §315 states that the auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity.

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):

1. The control environment.
2. The entity's risk assessment process.
3. The entity's process to monitor the system of internal control.
4. The information system and communication.
5. 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.

Every auditor is familiar with the five main components to a plan's system of internal control. These components include the control environment, risk assessment, control activities, information and communication, and monitoring (discussed previously). The components are described briefly below:

- **Control environment** – The attitudes and awareness of plan management and administrator.
- **Risk assessment** – The identification, analysis, and management of specific risks.
- **Control activities** – Policies and procedures to make sure that the plan directives are followed.
- **Information and communication** – Methods established to record, process, summarize, and report plan transactions.
- **Monitoring** – Assess quality of the system of internal control performance over time and communicating control deficiencies to those charged with governance.

In an employee benefit plan engagement, the key system of internal control areas include not just the components noted above but also the following plan-specific areas:

- Contributions and receivables;
- Distributions and payables;
- Participant data, accounts, eligibility;
- Investments;
- Payroll; and
- Financial reporting.

The auditor should also consider the following activities related to employee benefit plans that may include controls (both manual and automated IT) relevant to the audit:

- a. The activities, including IT activities, within payroll and the human resources or benefits (human resources information systems) that include information such as salary; hours worked; demographics (e.g., sex and date of birth); and date of hire and termination.
- b. Authorization and information processing for certain plan activities, such as:
 - i. Eligibility and enrollment;
 - ii. Employer and employee contributions; and
 - iii. Payment of distributions.
- c. Transmitting information between the plan sponsor's systems and service organizations.
- d. Approving, monitoring, and valuing plan investments.
- e. Monitoring information provided by service organizations.
- f. Monitoring activities outsourced to service organizations.
- g. The financial statement preparation and closing process.
- h. Maintaining the plan's tax advantaged status (for example, timely plan amendments and performance of applicable compliance tests).
- i. Maintaining substantial compliance with applicable laws and regulations (e.g., nonexempt transactions, reporting and disclosure, and income tax withholding on distributions).

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:

- Controls over journal entries and other adjustments as required by AU-C §240, *Consideration of Fraud in a Financial Statement Audit*;
- 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
- 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.

Regardless of whether an ERISA audit or an ERISA §103(a)(3)(C) audit is performed, auditors must obtain an understanding of the system of internal controls and determine whether or not the control has been implemented.

In an ERISA §103(a)(3)(C) audit engagement, the auditor is not required to obtain an understanding of the controls related to investments at the plan level. Investment controls at the plan level include investment purchases, sales, realized and unrealized gains and losses, and fair value. However, the auditor is required to document their understanding of the investment-related controls at the participant level regardless of scope. Therefore, the investment controls related to the participant's ability to change their investment allocations amongst the available investment options and the controls for investment income allocation to individual participant accounts should be documented in both ERISA and ERISA §103(a)(3)(C) audit engagements.

AU-C §315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, addresses the auditor's responsibilities to identify and assess the risks of material misstatement in the financial statements. Paragraph .03 of AU-C §315 states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through the understanding of the entity and its environment, including the entity's system of internal control. The process of obtaining an understanding is a continuous process of gathering, updating, and analyzing information throughout the audit. When documenting the system of internal control for an employee benefit plan, the auditor should obtain information from the plan sponsor regarding plan operation and administration as well as the service organizations.

Many small- to medium-sized plan sponsors do not have any readily available internal control documentation to provide to the auditors. Therefore, the auditors should perform procedures to gather this information.

The auditor should inquire about the process utilized by the plan sponsor to inform employees about their ability to participate in the plan and how they document the fact that all eligible employees have been informed about their ability to participate. This is an area often overlooked by auditors due to the fact that many plans have transitioned to electronic enrollments. In prior years, auditors would obtain copies of the enrollment form or a copy of the declination form. Due to the advances in technology, many employers no longer use hard paper copy forms and instead have opted to utilize the service organization's ability to enroll participants electronically. The auditor will be required to develop procedures to test eligibility in a different manner since the paper enrollments may no longer be available.

Note:

The controls surrounding payroll at the plan sponsor is an area noted by the DOL and peer reviewers where auditors are not adequately documenting the system of internal controls.

Auditors need to document their understanding of the system of internal controls for the payroll process. Payroll is a critical area for benefit plans, and auditors should understand the process in order to perform the required testing related to contributions and various other audit areas. The controls related to the payroll function need to be documented regardless of whether the plan sponsor handles payroll internally or outsources to a service organization. The payroll process begins at the time an employee is hired, and the information is recorded either manually or electronically. The auditor will need to document their understanding of how information is entered, processed, and approved starting at the hire date and including changes in pay, bonuses, and so on.

Information from the plan sponsor's payroll, time reporting, and human resources systems is often used as audit evidence when performing the audit of a plan. The auditor is responsible for gaining an understanding of how the plan operates and how information from these systems is relevant to the plan's financial statement assertions. For example:

- In a DC plan, the compensation paid or hours worked may be relevant to the participant deferrals and related employer matching contribution.
- In a contributory plan, participant contributions for active employees are deducted from an employee's paycheck through the payroll system.
- Demographic data, such as date of birth (age) or employment status, may be relevant to a participant's eligibility to participate in a plan or receive a distribution.
- Information from the payroll system may be used to determine the completeness of the active participants in a plan or to perform analytical procedures.

Additional considerations associated with the payroll process involve whether the information is electronic or hard copy. Paper personnel files with compensation and demographic information may not exist at the plan sponsor. The plan sponsor may only be able to provide screen shots and electronic reports. If the information is in electronic format, then the auditor may need to consider the IT application used to generate this electronic information.

When placing reliance on electronic audit evidence for tests of controls and substantive procedures, the auditor may establish a basis for reliance by:

- Determining the source of the audit evidence (which IT application produces the information).
- Testing the clerical accuracy of audit evidence.
- Performing tests if the electronic data to determine the completeness of the data flows to and from original source documents.

In some cases, auditors may determine that it is necessary to perform tests of controls related to payroll processing. However, if the auditor believes that the control environment does not support the prevention or detection and correction of material misstatements, the auditor may test the clerical accuracy of audit evidence and electronic data manually. For example, in lieu of tests of controls related to payroll processing, the auditor may perform manual procedures associated with demographic data, compensation, or hours from the payroll register to appropriate supporting evidence and reconciling compensation from the payroll register to the plan sponsor's general ledger.

Due to the fact that the payroll processing controls represent a significant component of an employee benefit plan's overall operation and administration, it is critical that the auditor obtain a detailed understanding of the system of internal controls associated with the payroll process.

In some situations, the payroll processing and human resource functions may be outsourced to a third-party service provider.

Note:

Another internal control area of concern is associated with the controls related to the distribution process.

In many cases, the plan sponsor utilizes or relies on the service organization for everything associated with benefit payments and distributions. While this may be a convenient service feature provided by the service organization, the plan sponsor, as a fiduciary of the plan, is still responsible for maintaining records to support the transactions that occur in the plan. Unfortunately, in many cases, the plan sponsors are not even aware when a distribution occurs. At a minimum, the plan sponsor should have controls in place that include things such as approving the distributions and vesting, receiving notifications when distributions are processed by the service provider and monitoring the service provider on a regular and ongoing basis.

IV. Service organization control reports

Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization*, was finalized by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) in January 2010. SSAE No. 16 effectively replaces SAS No. 70 as the authoritative guidance for reporting on service organizations. SSAE No. 16 was formally issued in April 2010 with an effective date of June 15, 2011. There are three different types of reports available for service organizations and they include the following:

- Service Organization Control Report 1;
- Service Organization Control Report 2; and
- Service Organization Control Report 3.

Under SSAE No. 16, the reports on controls at a service organization will be referred to as Service Organization Control Reports (SOC's) and will still be available as a Type 1 or Type 2.

Probably the single most important aspect to understand is that the SOC framework represents the AICPA's keen understanding of the complexities that have evolved over the last two decades for service organizations and the need to provide auditors with tools to meet the growing compliance demands of these organizations. As such, the AICPA's revamped the reporting on controls for service organizations from that of a single, antiquated standard (SAS No. 70) to a new comprehensive framework (SOC) that changed the reporting requirements for service organizations.

SOC 1SM reports are to be utilized for service organizations reporting on controls relevant to internal control over financial reporting (ICFR). SOC 2 reports will be utilized for reporting on controls for the growing list of information technology (IT) related organizations, such as cloud computing, Software as a Service (SaaS), managed services, along with data centers, just to name a few. SOC 3, similar in framework to that of SOC 2, will also likely be used for IT related service organizations, ultimately resulting in a general use report available to the public.

Due to the significance of information maintained by insurance companies, trustees and custodians, as well as other service organizations, it is imperative that the auditor understand the controls that are in place at the service organizations. In order to do this, the auditor should obtain a SOC 1 report, from each service organization.

Discussion question:

On average, how long does it take to read, review, and document your understanding of the information included in the SOC report? How do you document your understanding?

The service organization must choose between the two types of service audit reports that can be performed:

- A Type 1 SOC report only describes the control policies and procedures that are in place at the service organization.
- A Type 2 SOC report describes the control policies and procedures that are in place as well as tests to see that the controls are in place and functioning properly.

At a minimum, an auditor should obtain a Type 1 report in order to obtain an understanding of the controls at the service organization. However, in order to reduce control risk below the maximum and reduce the overall level of substantive testing, the auditor should obtain a Type 2 SOC 1 report. Please note that the key word is *reduce* substantive testing, not eliminate!

Note:

The DOL and peer reviewers are still noting that auditors over rely on the SOC reports. Please remember that audit procedures can NEVER be eliminated based on reliance on the SOC report – they can only be reduced.

There also appears to still be some confusion between an ERISA §103(a)(3)(C) and the utilization of SOC reports. The SOC report is NOT connected or related to the limited-scope audit exemption in any manner! An ERISA §103(a)(3)(C) audit is applicable if the plan administrator obtains a valid certification from an eligible institution, whereas the SOC reports provide information associated with the system of internal controls at the service organization.

Paragraph .03 of AU-C §402 states that services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets.

A service organization's services are part of the user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger (or equivalent such as a trust statement), and reported in the financial statements;
- The related accounting records, supporting information, and specific accounts in the user entity's financial statements that are used to initiate, authorize, record, process, and report the user entity's transactions. This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form;
- How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
- The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
- Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

There are many services provided by service organizations that may be relevant to an employee benefit plan audit. A few examples include:

- Maintenance of accounting records at the plan and participant level.
- Investment management and transaction processing.
- Safeguarding of assets.
- Benefit payment processing.
- Participant loan processing and maintenance.
- Participant enrollment and allocation and deferral changes.

Please note that there may be more than one service organization for the plan. The auditor should ensure that they have all of the relevant SOC reports for all of the service organizations as applicable. Auditors should document their reading and understanding of the SOC report. This documentation may be in the form of a memo, checklist, narrative, etc.

Caution:

The completion of an audit program related to the SOC report may not be considered sufficient documentation of the auditors reading and understanding of the SOC report.

In order to properly read and understand a SOC report, auditors should at a minimum consider the following factors:

- Appropriate SOC report for the plan.
- Type I or II.
- Period covered by the SOC report.
- Type of opinion.
- Professional expertise of service auditor.
- Use of subservice organizations.
- User entity controls.
- Relevant controls tested.
- Exceptions noted in controls tested.

If exceptions are noted in the SOC report, then the auditor should evaluate the response provided by management. Depending on the nature of the exception, the auditor may determine that the control cannot be relied upon and therefore, substantive procedures cannot be reduced related to that control. The auditor should also consider whether or not exceptions noted in controls tested at the service organization represent deficiencies in internal control that should be reported to those charged with governance.

The SOC report is provided as a resource/tool to user entities (plan sponsors). However, many plan sponsors mistakenly believe that the SOC report is necessary for benefit plan audit. SOC reports do assist the plan auditor in understanding the controls at the service organization that are relevant to the plan operation and administration but ultimately, plan sponsors should be using the SOC reports as one tool to monitor the service organization.

V. Risk identification and assessment

Many peer reviewers have noted that the risk assessments performed by auditors do not sufficiently document the identified risks and the link to the audit procedures to be performed. Therefore, it is necessary to review the risk assessment process and the related documentation.

AU-C §200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with GAAS.

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.

The auditor should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for:

- a. The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and
- b. The design of further audit procedures in accordance with AU-C §330.

The auditor should design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

The risk assessment procedures should include the following:

- a. Inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
- b. Analytical procedures; and
- c. Observation and inspection.

During the planning stages of the engagement when auditors are gathering information, certain risks may be identified that will need to be assessed at the financial statement level and the assertion level. Therefore, the auditor should be familiar with the risks associated with benefit plan audits in general as well as the specific risks associated with benefit plans.

Paragraphs .A38-.A39 of AU-C §200 state that the risks of material misstatement exist at the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Audit risk factors associated with employee benefit plan audits at the financial statement level may include:

- Lack of oversight and monitoring of plan operations and service providers.
- Lack of segregation of duties and safeguarding of assets.
- Lack of financial reporting expertise.
- Lack of concern in regard to financial reporting.
- Plan amendments.
- Decisions to terminate the plan.
- Susceptibility of plan assets to theft or fraud.
- Participating in prohibited transactions with parties in interest.
- Changing trustees or custodians on a frequent basis.
- Changes in plan personnel.
- Ignoring DOL rules and regulations.

Paragraph .A40 of AU-C §200 states that risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Paragraph .A44 of AU-C §200 explains that the assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in nonquantitative terms (for example, high, medium, or low).

Areas that may present risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures include:

- Valuation of investments, particularly those with unobservable inputs.
- Accounting and disclosure of types of investments specific to employee benefit plans, such as insurance products, stable value products, derivatives, and securities lending.
- Accuracy of contribution and benefit payment amounts.
- Accuracy and completeness of census data used by the actuary in determining the amount of benefit obligations.
- Accuracy of the estimate of claims incurred but not reported obligation.
- Accuracy and completeness of transactions initiated by telephone or electronic means, such as the Internet or intranet.
- Accuracy and completeness of opening balances in initial audits or reaudits and availability of records.
- Accuracy and completeness of participant data.
- Availability of appropriate service organization reports.
- Appropriate disclosure of related-party transactions and party in interest transactions.
- Regulatory implications of plan design and operation, including compliance with applicable laws and regulations.

Audit risk factors include the nature of the plan, external influences possibly affecting the plan, financial results, nature of the audit engagement such as the initial audit year, and engagement history. The list above contains examples of audit risk factors for various types of benefit plans.

Specific risks associated with defined contribution plans include:

- Individual participant account balance activities and reconciliations.
- Hard-to-value investments.
- Disclosure requirements, which continue to evolve.
- Significant transactions that are processed by an outside service organization that does not have a SOC 1 report, or the report contains qualifications or carve-outs that are excluded from the scope of the report.
- Initial audits.

For identified risks of material misstatement at the assertion level, the auditor should assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, the auditor should take into account the degree to which:

- a. Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and
- b. The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.

The auditor should determine whether any of the assessed risks of material misstatement are significant risks in accordance with the new definition of significant risk per SAS No. 145. The auditor should determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level.

A. Assessing control risk

For identified risks of material misstatement at the assertion level, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at the maximum level. As a result, the assessment of the combined risk of material misstatement would then be the same as the assessment of inherent risk. Control risk can only be reduced if the auditor tests the operating effectiveness of the control.

AU-C §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.

Examples of plan provisions often included in a plan instrument by audit area (this list is not all-inclusive):

- Individual participant accounts:
 - Participation and eligibility requirements;
 - Types of contributions and distributions;
 - Timing of contributions;
 - Contribution limitations;
 - Investment of contributions;
 - Allocations to participant accounts;
 - Forms of distributions;
 - Benefit commencement dates;
 - Vesting and forfeitures;
 - Service requirements and credits;
 - Participant loans;
 - Transfers; and
 - Administration of the plan.
- Contributions and contributions receivable:
 - Participation and eligibility requirements;
 - Types of contributions;
 - Timing of contributions;
 - Contribution limitations;
 - Investment of contributions
 - Use of forfeitures;
 - Service requirements and credits; and
 - Allocations to participant accounts.
- Distributions and related obligations:
 - Eligibility requirements (distributable events);
 - Types of distributions;
 - Forms of distribution;
 - Benefit commencement dates;
 - Determination of benefits;
 - Vesting;
 - Service requirements and credits; and
 - Allocations to participant accounts.
- Claims (in a health and welfare plan):
 - Eligibility requirements;
 - Types of claims;
 - Claims coverage; and
 - Determination of claims.
- Loans to participants:
 - Eligibility requirements;
 - Loan terms; and
 - Allocations to participant accounts.
- Investments and investment income:
 - Investment of contributions;
 - Administrative provisions;
 - Direction of investments; and
 - Allocations to participant accounts.
- Expenses:
 - Administrative provisions; and
 - 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.

Although the term *significant class of transactions, account balance, or disclosure* is used within GAAS, particularly within AU-C §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 §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.

One of the questions that auditors should ask is "What Could Go Wrong?" Listed below are several examples of things that could go wrong:

- Lack of a service organization report for a major service organization.
- Inability to obtain an auditor login to access plan information on the Internet.
- Plan sponsor in operating the plan does not use the definition of compensation that is contained in the plan document.
- Accuracy and completeness of the transition from hard copy personnel files to electronic files may be lacking.
- Missing participant information in personnel files.
- Reductions in workforce triggering a partial plan termination, with incorrect vesting.
- Improper calculation of vesting determinations with respect to terminations.
- Changing service organizations without controls over the transition.

The items listed above will have an impact on the auditor's risk assessment and potentially the procedures that are performed during the audit. In the event that one of these items are identified, then the auditor may consider visiting the service organization or confirming transactions directly with the service organization or the participants or evaluating termination dates and reconciling transfers between service organizations.

In accordance with paragraph .06 of AU-C §315, the risk assessment procedures should include:

- a. Inquiries of management, appropriate individuals within the internal audit function (if such function exists), and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error;
- b. Analytical procedures; and
- c. Observation and inspection.

In accordance with paragraph .11 of AU-C §315, the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material

misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. The auditor should include certain information relating to this discussion in the audit documentation, as required by paragraph .33 of AU-C §315.

The engagement partner may discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge, such as valuation specialists, actuaries, and tax specialists. Paragraph .A21 of AU-C §315 states that this discussion may be held concurrently with the discussion among the engagement team to discuss the susceptibility of the entity's financial statements to fraud, as required by AU-C §240.

Note:

These discussions can be held for several plans concurrently relating to changes in external environmental factors affecting all plans or all plans of a certain type; however, the discussions relating to internal environmental factors for each plan would be considered separately for each plan and appropriately documented in the working papers as such.

To provide a basis for designing and performing further audit procedures, paragraphs .26-.27 of AU-C §315 state that the auditor should identify and assess the risks of material misstatement at the financial statement level and relevant assertion level for classes of transactions, account balances, and disclosures. For this purpose, the auditor should:

- a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements;
- b. Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- c. Relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and
- d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

The following table per the 2023 *Audit and Accounting Guide for Employee Benefit Plans* shows the three categories of assertions for different types of potential misstatements and the various forms they may take, including examples for employee benefit plans.

	Classes of Transactions, Events, and Related Disclosures for the Period Under Audit	Account Balances and Related Disclosures at the Period's End
Occurrence or Existence	Transactions and events that have been recorded in the statements of changes in net assets available for benefits and changes in the actuarial present value of accumulated plan benefits, or disclosures in the notes to the financial statements, have occurred during the period covered by the financial statements and are in accordance with the plan document, if applicable; and events pertain to the plan. Example: All investment transactions are recorded and disclosed during the period covered by the financial statements and are in accordance with the plan document, if applicable. Example: Participants receiving benefits during the year were eligible under the terms of the plan. Example: Contributions and benefits paid are properly recorded during the period covered by the financial statements and are in accordance with the plan document.	Assets and liabilities included in the statement of net assets available for benefits and accumulated benefit obligations exist as of the end of the period covered by the financial statements. Example: Investments exist as of the end of the period covered by the financial statements. Example: The actuarial present value of accumulated plan benefits exists as of the end of the period covered by the financial statements. Example: Notes receivable from participants, contributions receivable, and accrued expenses exist as of the end of the period covered by the financial statements.
Rights and Obligations	—	The plan holds or controls the rights to assets and liabilities, and accumulated plan benefits are the obligations of the plan as of the period covered by the financial statements. Example: Investments are owned by the plan and free of liens, pledges, and other security interests or, if not, the security interests are identified. Example: Claims incurred but not reported are obligations of the plan that arose during the period covered by the plan's financial statements. Example: Actuarial present value of accumulated plan benefits are obligations of the plan.

Completeness	All transactions and events that should have been recorded in the financial statements have been recorded in the financial statements, and all related disclosures that should have been included in the financial statements have been included. Example: All participant contributions that should have been recorded under the terms of the plan have been recorded in the financial statements, and participant data is complete and accurate. Example: The benefit obligation for all eligible participants that should have earned benefits under the terms of the plan have been recorded. Example: All administrative expenses that should have been recorded under the terms of the plan have been recorded.	All assets, liabilities, and benefit obligations that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. Example: All assets relating to participant contributions that should have been recorded under the terms of the plan have been recorded. Example: Benefit obligations due under the plan relating to eligible participants have been recorded.
Accuracy, Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. Example: Investment principal and income transactions are properly recorded, and investment transactions are properly valued in accordance with accounting principles generally accepted in the United States of America as promulgated by FASB (U.S. GAAP.) Example: Participant contributions have been calculated in accordance with the plan document and in accordance with the participant's request. Example: Benefit payments have been calculated in accordance with the plan document and the participant's election.	Assets, liabilities, and accumulated benefit obligations have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described. Example: Investments are valued at period-end in accordance with U.S. GAAP. Example: Accrued liabilities are included in the financial statements at appropriate amounts. Example: The present value of accumulated benefit obligations is included in the financial statements at appropriate amounts, based on appropriate assumptions.
Cut-off	Transactions and events have been recorded in the correct accounting period. Example: Employer contributions receivable have been properly recorded. Example: Claims payable and claims incurred but not reported have been properly recorded	—

Classification	Transactions and events have been recorded in the proper accounts. Example: Benefit payments to participants have been properly classified. Example: Insurance premiums paid have been properly classified. Example: Administrative expenses have been properly classified.	Assets, liabilities, and accumulated benefit obligations have been recorded in the proper accounts.
Presentation	Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework. Example: All disclosures relating to participant contributions that should have been included in the financial statements have been included.	Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework. Example: Plan benefit obligation information (for example, vested and nonvested participants) is appropriately presented. Example: Fully benefit-responsive investment contracts are appropriately presented in accordance with the applicable financial reporting framework. Example: Notes receivable from participants are appropriately presented as a receivable, not included as an investment.

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 §240 and AU-C §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 §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.

In accordance with Paragraph .05 of AU-C §330, the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. Paragraph .A1 of AU-C §330 states that overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism;
- Assigning more experienced staff or those with specialized skills or using specialists;
- Providing more supervision;
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed; and
- Making general changes to the nature, timing, or extent of audit procedures (for example, performing substantive procedures at period-end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence).

Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balances, and disclosure.

Note:

Paragraph .19 of AU-C §330 states that the auditor should consider whether external confirmation procedures are to be performed as substantive procedures.

VI. Consideration of fraud

AU-C §240 addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In accordance with paragraph .05 of AU-C §240, an auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. See paragraphs .12-.15 of AU-C §240 for requirements relating to maintaining professional skepticism and discussion among the audit team members related to potential fraud risks.

Discussion question:

Do you believe that you appropriately document and link the identified risks associated with your employee benefit plans to the actual audit procedure?

See the appendix to this chapter for an excerpt of a risk assessment summary for a 401(k) plan.

Discussion question:

How many of you still believe that you appropriately document and link the identified risks associated with your employee benefit plans to the actual audit procedure?

VII. Conclusion

The information in this chapter discussed the guidance related to the application of GAAS during the planning of an employee benefit plan audit. Specifically, obtaining an understanding of the plan's operations and control environment; assessing and responding to the risk of material misstatement and developing an overall audit strategy. This information should assist an experienced auditor with more efficient, effective, and comprehensive planning and performing an employee benefit plan engagement.

Chapter 3 Appendix: Risk Assessment Summary for a 401(k) Plan

Identified Risk	Type of risk	Responses
Management override	Significant and Fraud	Management override of controls is addressed by procedures in general audit programs and include: • Procedures to incorporate unpredictability in the audit from period to period; • Consideration of selection and application of accounting policies; • Review of accounting estimates for bias; • Evaluation of business rationale for unusual transactions; and • Evaluation of appropriateness of fraud-related inquiries performed. Also, I will perform the following: • Reconcile contributions between payroll records and custodian; • Verify subsequent receipts for contributions receivable; and • Determine that distributions are made to eligible participants, accurately calculated, and vouch to supporting documents, reviewing 1099R as applicable and tracing distributions to participant account statement. Auditor will inquire of Plan Sponsor personnel regarding their knowledge of any actual or suspected fraud; Auditor will also maintain appropriate professional skepticism throughout the engagement. There is some mitigation of risks due to the involvement of third-party administrator and the fact that the participants make initiate changes in deferrals, distributions, loan requests, etc. via online transactions with third party administrator. The Plan Sponsor does not have the authority or ability to make changes to participant accounts.
Improper certification	Significant	Evaluate the certification obtained from Life Insurance Company to ensure that it is from an eligible institution and valid with the words complete and accurate, signed, etc. As a response, I will review investment options available for appropriateness; confirm with client there were no major changes to the Plan in the current year; review amendments, if any; review a sample of withdrawals and discuss the prior year internal control communication to ensure the plan sponsor reviewed and implemented the suggested control changes.
Noncompliance with laws and regulations	Significant	• Review and evaluate Plan management's procedures to ensure compliance with laws and regulations. • Inquire of those charged with governance. • Maintain awareness during audit for potential issues that may affect noncompliance.

		Risks of Material Misstatement		Risk Assessment				Response	
Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Significant or Fraud Risk	Assertions	I/R (H, M, L)	C/R (H, M, L)	Assessed RMM (H, M, L) ^a	Audit Approach (L, B, E) ^b	Linkage/ Comments ^c
Contributions Received and Receivable	Yes	Improper revenue recognition due to fraud Contributions not remitted timely (E/O, C, CO) Incorrect definition of compensation (E/O, C, A)	S & F S S	E/O C A/CL CO	M M M L	M M M M	M M M M	B B B B	See box below
CR=M based on tests of controls, reconciliation, review and approval of contributions and my reliance on the controls tested and operating effectively in the type 2 SOC 1. Fraud and significant risk responses: reconcile total contributions per payroll to contributions received by plan. Review remittance schedule prepared by client for accuracy; test sample of participants contributions for accuracy and agree to participant accounts; test definition of compensation in accordance with plan document. Inherent risk – See risk assessment memo for basis for assertion. Contributions are not a complex audit area, are easy to re-compute and verify, and there is very little judgement needed, which is why inherent risk was assessed below H even for assertions related to the identified risk above. MGC deemed inherent risk as moderate for all assertions except CO as this area has a large amount of activity, a high balance (contributions received) and includes a significant identified risk. Cutoff (CO) at year end is limited to the last payroll period of the year and can be easily traced to the last payroll report so it is easy to identify as a receivable. Therefore, inherent risk was assessed as low. Additionally, the identified risk does not affect CO. Additionally, MGC identified the use of an “Incorrect Definition of Compensation” to calculate contributions as an Identified Risk affecting the Plan. If the definition of compensation per the Plan Agreement is not followed, then it could result in either excess contributions or a shortage of contributions for each affected Plan participant.									
Investments, Derivatives, and Related Incomes	N/A Limited Scope Audit			E/O C R/O V A/CL CO					
Participant Data and Employee Contributions	Yes	Employee contributions calculated inaccurately based on participants request or plan document	S	E/O C R/O V A/CL CO	M M M M M M	M M M M M M	M M M M M M	B B B B B B	See box below

		Risks of Material Misstatement		Risk Assessment				Response	
Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Significant or Fraud Risk	Assertions	I/R (H, M, L)	C/R (H, M, L)	Assessed RMM (H, M, L) a	Audit Approach (L, B, E) b	Linkage/ Comments c
CR=M based on testing on controls (reconciliation, review and approval of contributions and my reliance on the controls tested and operating effectively in the type 2 SOC 1). Sample of participants will be selected to test for eligibility and recalculate their contribution based on participant election and definition of compensation in plan document; reconcile total plan assets to participant accounts. Inherent risk – See below and risk assessment memo for basis for assertion. Participant data is not a complex area; there is no judgment needed (as the Plan personnel follow plan document and participant elections); the TPA completes annual nondiscrimination testing; there is very good segregation of duties; and competent HR, payroll, and accounting staff. While these facts lead to a decreased inherent risk, due to the fact that this area involves high account balances and there is a large amount of activity, MGC deemed the inherent risks to be moderate. I/R was assessed below maximum for all assertions due to the lack of complexity of the transactions. E/O – E/O is considered moderate as Custodian maintains individual accounts for each participant making verification of existence of each account simple. C – C is considered moderate as participant data is maintained by the participant at the Custodian. R/O – I/R considered moderate as R/O regarding contributions and participant data are not complex. Contributions are maintained on a per participant basis. V – I/R considered moderate as Valuation of EE contributions is not complex. Contributions are withheld directly from payroll and remitted of the plan timely. A/CL – I/R considered moderate due to volume of transactions and number of participants. CO – I/R considered moderate as MGC does not expect an unusual number of transactions near year end.									
Benefit Payments	Yes			E/O C R/O V A/CL CO	L L L L L L	M M M M M M	M M M M M M	B B B B B B	See Box below
CR=M based on testing on controls (reconciliation, review and approval of contributions and my reliance on the controls tested and operating effectively in the type 2 SOC 1). Fraud Response/Significant: Sample of participants will be selected to recalculate their distribution amount based on participants' election and plan document. Inherent risk – See below and risk assessment memo for basis for assertion. The benefit payment process is handled by the Custodian (with Type II service auditor's report); the Custodian understands plan rules and provisions; and no issues were noted in prior year audits.									
Participant Accounts	Yes			E/O C R/O V A/CL CO	L L L L L L	M M M M M M	M M M M M M	B B B B B B	See box below

		Risks of Material Misstatement		Risk Assessment				Response	
Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Significant or Fraud Risk	Assertions	I/R (H, M, L)	C/R (H, M, L)	Assessed RMM (H, M, L) a	Audit Approach (L, B, E) b	Linkage/ Comments c
CR=M based on testing on controls (reconciliation, review and approval of contributions and my reliance on the controls tested and operating effectively in the type 2 SOC 1). Reconcile total account balances per recordkeeper to custodian reports; test investment income allocated to participant accounts and employer contributions. Inherent risk – See below and risk assessment memo for basis for assertion. Participant accounts are processed by the Custodian (with Type II service auditor's report); the Custodian understands plan rules and provisions; and no issues were noted in prior year audits. Audit steps included in this significant audit area relate to individual account balances, investment allocations (and allocations of expenses) and contributions. Because the activity is significant and the balances are large, this is considered a significant audit area. However, all other audit areas within this risk assessment form have addressed items that relate to participant accounts and as such, testing is performed throughout the audit binder related to participant accounts. MGC will reconcile the total participant account balances to the total net assets. Additionally, MGC will test the allocation of investment income to participant accounts. E/O and C are considered low as the transactions are not complex and the Custodian maintains separate accounts for each investor. R/O – I/R is considered low as R/O regarding contributions and participant data are not complex and are assessed and tested in other audit areas. Contributions/participant activities are maintained on a per participant basis. V – I/R is considered low as contributions; investment income and loans/distributions are not complex. Transactions are recorded by the Custodian who has working controls in place. A/CL – I/R considered low due to the simple nature of the transactions. Transactions are recorded by the Custodian who has working controls in place. CO – I/R considered low due to limited number of transactions near year end.									
Notes Receivable from Participants				E/O C R/O V A/CL CO	L L L L L L	M M M M M M	M M M M M M	B B B B B B	See box below

		Risks of Material Misstatement		Risk Assessment				Response	
Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Significant or Fraud Risk	Assertions	I/R (H, M, L)	C/R (H, M, L)	Assessed RMM (H, M, L) a	Audit Approach (L, B, E) b	Linkage/ Comments c
CR=M based on testing on controls (reconciliation, review and approval of contributions and my reliance on the controls tested and operating effectively in the type 2 SOC 1). Fraud/Significant risks: several outstanding participant loans will be selected to test that the loan was in accordance with plan document and loan provisions. Inherent risk – See below and risk assessment memo for basis for assertion. Participant loans are not considered high risk as their balance is covered by the Certified Report. Therefore, inherent risk is assessed at low for all assertions and audit procedures will be performed accordingly. This audit area is still considered a significant audit area based on the nature of the account, which are participants borrowing money from their own Plan account, and the regulatory and Plan rules surrounding this audit area. MGC assessed inherent risk below maximum due to the limited number of transactions and the lack of complexity of the transactions. Refer to the tailored audit program/ memos for procedures performed. The basic procedures address the risk assessment levels and therefore MGC has determined the basic procedures to be appropriate. E/O – I/R considered low as loans are issued and maintained by the Custodian, existence is easily verifiable. C – I/R considered low as a certified report from the Custodian is obtained that certifies the accuracy and completeness of the data. R/O – I/R considered low as the R/O surrounding loan balances is simplistic in nature and loan requirements are not complex. V – I/R considered low as loan requirements are not complex and value is easily determined. A/CL – I/R considered low due to nature of transactions and no significant F/S disclosure requirements. CO – I/R deemed low as MGC does not expect significant volume of transactions near year end.									
Other:	NA			E/O C R/O V A/CL CO					

Notes

Investments

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Investments

Learning objectives

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

- Understand the various investment options offered by the plan; and
- Differentiate between the audit procedures for a full-scope and limited-scope engagement.

I. Introduction

This chapter will discuss the various investment related issues that should be understood by auditors in order to properly complete an audit. Regardless of scope, the investment must be properly identified and disclosed in accordance with the rules, regulations, and accounting standards.

Typically for DC plans, participants are offered an array of investment options in which to direct their account balances and have different methods of holding those investments. Some of these investment options or methods of holding investments include common or collective trusts (CCTs), registered investment companies (RICs), contracts with insurance companies, pooled separate accounts (PSAs), and master trusts.

A. Investment service providers

Auditors should be familiar with the various investment options regardless of the scope of the audit. In an ERISA limited-scope audit, the auditor is instructed by the plan administrator not to perform any procedures related to investments and investment related information that has been certified by the trustee or custodian. However, the auditor is still required to obtain an understanding of the investments offered by the plan regardless of whether the engagement is an ERISA audit or ERISA §103(a)(3)(C) audit.

Furthermore, there are required disclosures that must be included in the notes to the financial statements identifying the types of investment held by the plan. In order to evaluate the footnotes properly, auditors should understand the types of investments held by the plan.

The investments may be held by a trustee or a custodian depending on the relationship established with the service organization. Plan sponsors and auditors should understand the responsibilities of all parties involved with the investments.

1. Investment managers

The investment manager or adviser generally provides investment advice, research services, and certain administrative services under a contract, commonly referred to as the investment advisory agreement.

2. Custodians

Custody of the plan's investments is typically entrusted to a bank, insurance entity, or a member of a national securities exchange that is responsible for their receipt, delivery, and safekeeping under a contract, commonly referred to as the custodial agreement. A plan may also enter into a subcustodial agreement to provide a custody function for other types of investments, such as foreign securities.

3. Trustees

Trustees generally are responsible for the safekeeping of the investments covered under the trust agreement. Sometimes, however, plans will not appoint a trustee to maintain custody of the plan's investments but, rather, will self-administer the investments and investment transactions and provide for their safekeeping with a custodian.

In a directed trust, including a participant-directed trust, the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, the participant, or the plan's investment adviser. A discretionary trust differs in that the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions. A discretionary trust gives the trustee authority to purchase and sell investment assets within the framework of the trust instrument. Many variations of investment authority exist that may be given to the trustee, such as a combination of discretionary and directed arrangements within a trust. Furthermore, a plan may have one or more trusts as well as one or more custodial or safekeeping accounts.

4. Investment recordkeepers

The investment recordkeeper maintains information regarding the positions of investments and related activity for each plan based on information provided by the investment adviser and trustee or custodian. Usually, the trustee or custodian also maintains investment records for the plan. However, in certain master trust or commingled investment arrangements, it may be necessary for the plan sponsor to engage a separate recordkeeper to maintain the investment records for each plan.

B. Investment policy statement

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.

Discussion question:

How many of you have plans that have an investment policy statement individualized for their plan?

Specifically, the investment policy statement:

- Defines the plan's investment objectives.
- Defines the roles of those responsible for the plan's investments.
- Describes the criteria and procedures for selecting investment options and investment managers.
- Establishes investment procedures, measurement standards, and monitoring procedures.
- Describes ways to address investment options and investment managers that fail to satisfy established objectives.
- 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 following is a sample Investment Policy Statement (IPS). Please keep in mind that there is no perfect IPS, nor will you find complete agreement on what one should contain, how it should be structured, or how it should be written. It is always advisable to have an ERISA attorney review any IPS before it is used. The auditor should be familiar with the provisions of the investment policy statement in order to properly advise the plan sponsor.

Investment Policy Statement for the XYZ 401(k) Profit-Sharing Plan
<u>Summary of Plan Information</u> Plan Sponsor: XYZ, Inc. Plan Name: XYZ 401(k) Profit-Sharing Plan Date This Policy Statement Adopted: February 11, 20X5 <u>Statement of Purpose for the Policy and the Plan</u> The XYZ 401(k) Profit-Sharing Plan (Plan) is a defined contribution retirement plan available to all eligible employees. The Plan's purpose is to provide a cash or deferred arrangement for Plan participants (for the purposes of this document, participants will include beneficiaries and any parties in interest as defined within ERISA). Investment of Plan assets will be made for the sole interest and exclusive purpose of providing benefits to participants. It is the intent of the Investment Committee (Committee) <i>[insert name of your committee or board of directors or board of trustees depending on the makeup of your Plan administration]</i> to provide a range of investment options that will enable participants to invest according to varying risk tolerance, savings time horizon, and other financial goals. The Plan's investment funds will be selected and monitored with the skill, care, and diligence that a prudent individual acting in a like capacity would undertake and in accordance with all other aspects of applicable law, including the requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, and Sections 401(a) and 501(a) of the Internal Revenue Code of 1986 (Code), as amended. The Plan is intended to qualify under the qualified cash or deferred arrangement rules of IRC §401(k). The Plan is a participant-directed individual account plan that it is intended to comply as a 404(c) Plan within the meaning of the Department of Labor Regulations under ERISA §404(c) and as such, it provides individual accounts for Plan participants to select how these individual accounts shall be invested and therefore, no fiduciary shall be liable for any loss that results from a participant's exercise of control over the investment of his or her participant accounts. The purpose of the document is to provide the Committee with guidance in discharging certain fiduciary responsibilities. It creates no obligation to act in any way. The Committee will monitor all of the evaluation criteria as well as any other material issues when making decisions concerning the Plan's investment funds. To maximize diversification and lessen risk to the extent possible, the Plan offers a balanced portfolio of investment funds composed of equity, fixed income, and cash equivalent securities, and, as such, is intended to be more aggressive than fixed income portfolios and less aggressive than purely equity-oriented portfolios. The Plan offers a broad range of diversified investments that will enable a participant to construct a portfolio with aggregate risk and return characteristics at any point within the participant's desired range. Adherence to the specific investment objectives and criteria contained herein will be evaluated over a full-market cycle, which historically has been five to seven years. The Committee may, from time to time as warranted, modify these objectives and criteria according to the Committee's discretion in consultation with such financial advisors as it deems appropriate.

Because participants in the Plan ultimately are responsible for their own investment decisions, the Committee aims to provide participants with the following capabilities:

- Choose from a minimum of five diverse alternative investment fund categories, each with materially different risk and return characteristics, at least one of which will provide for a high degree of safety and capital preservation.
- Make investment decisions at least quarterly.
- Receive or have access to the following information in accordance with ERISA §404(c) (Please refer to ERISA §404(c) for a complete list of information that participants will receive), as updated:
 - A description of the investment alternatives available under the Plan including a general description of the investment objectives, risk and return characteristics, and type and diversification of assets comprising each alternative;
 - A description of any transaction fees or expenses charged to the participant's account, and information on fund costs and fees that reduce the rate of return to participants (expense ratios); and
 - Fund prospectuses, annual reports, and semiannual reports.
- A description of how, when and to whom participants may give investment instructions or identification of designated investment managers.
- Protection of capital gains to obtain a positive return over a given market-cycle.
- Asset growth, exclusive of contributions and withdrawals, should exceed the rate of inflation to preserve purchasing power.
- Obtain stable and consistent returns.

Approach to Performance and Measurement

When selecting investment options, each investment manager must meet certain minimum criteria:

1. They must be a bank, insurance company or investment management company or an investment adviser under the Registered Investment Advisers Act of 1940.
2. They must be operating in good standing with regulators and clients, with no material pending or concluded legal actions.
3. They must provide detailed additional information on the history of the firm, its investment philosophy and approach, and its principals, clients, locations, fee schedules and other relevant information.

The Committee will review the investment objectives and risk characteristics, historical performance, and expenses related to each available Plan investment option and choose a specific option based on these procedures and objectives. The Committee recognizes that risk, volatility, and the possibility of loss in purchasing power are present to some degree in all types of investment vehicles. While risk high levels of risk are to be avoided, the assumption of risk is warranted and encouraged to allow the Committee the opportunity to achieve satisfactory long-term results consistent with these procedures and objectives.

Generally, all investment options are expected to perform as well as or better than their prescribed performance standards, net of fees. In any case, the Committee shall have full discretion and reserves the right to offer or terminate an investment option at any time, for any reason. Once the decision to terminate an investment option is made, asset transfer and liquidation should be handled to the best advantage of the plan using one of the following approaches:

- Remove and replace with an alternative manager and move existing assets directly to the alternative manager.
- Freeze the assets managed by the terminated manager and direct new assets to a replacement manager.
- Phase out the manager over a specific time period.
- Continue the manager but add a competing manager.
- Remove the manager and do not provide a replacement manager.

Monitoring of Investment Options

The on-going monitoring of investments will be a regular and disciplined process. While frequent change is neither expected nor desirable, the process of monitoring investment performance relative to specified guidelines is an on-going process.

The Committee will review periodically the investment managers' progress in meeting the Plan's investment objectives on at least a quarterly basis. The board of directors will review the Plan's investment offerings and the Committee's actions pertaining to investment options at least once per year. Generally, the Committee realizes investment managers should be given a full market cycle to achieve stated objectives, therefore greater weight will be given to market-cycle performance than performance in any given year. However, the Committee recognizes that economic, political, social, or other changes could occur requiring action sooner than a full-market cycle. Investment options that consistently underperform in terms of risk and return will be carefully reviewed to determine if any action is warranted.

Default Investment Fund Selection

For those participants who fail to give investment instructions regarding either their balance in the Plan or future contributions to the Plan, the Committee has determined that such balances and contributions will be invested in a Qualified Default Investment Alternative (QDIA) as described in U.S. Department of Labor regulations. The Committee, with the assistance of the plan recordkeeper where appropriate, will:

- Select a *[insert type of investment fund]* as the default investment option under the Plan.
- Notify each participant 30 days in advance of the initial investment and annually thereafter with a description of the investment, the participant's rights to change the investment and how to obtain additional information or to make changes.
- Allow the participant to provide the opportunity to direct investments in its account any time prior to or after the placement of funds in the QDIA.
- On an ongoing basis provide the same level of information as the other investment options in the Plan.

In conducting these activities, the Committee will follow the requirements of the Plan's ERISA §404(c) Policy Statement.

Participant Investment Education

In developing a continual participant investment education program, the Plan will select funds and provide supporting material with consideration for the following:

- The number of funds offered should be limited to promote participant understanding without sacrificing the objectives set forth in this policy.
- The Plan Sponsor should provide general information relating to the economy and capital markets as part of the investment education program.
- Participants should be encouraged to select an appropriate asset allocation (based on their risk tolerance, their time until retirement and other factors relating to their personal financial status) and avoid attempts to time the market.
- The Plan Sponsor should educate participants on the relative risk and return of investing in different asset classes and how diversified investing can reduce the risk of investing.

Coordination With the Plan Document

Notwithstanding the foregoing, if any term or condition of this investment policy conflicts with any term or condition in the Plan, the terms and conditions of the Plan shall control.

On Behalf of the XYZ Inc. 401(K) Profit-Sharing Plan:

Name:

Title:

Date:

C. Participant-directed investments

A DC plan may offer a participant-directed program whereby participants choose among various investment options and may periodically change their investment selections. The available options may include pooled fund vehicles (such as RICs, CCTs, or PSAs), employer securities, and separately managed accounts. When a participant is permitted to redirect or transfer funds from investments originally directed by the employer, those investments are also considered participant directed. For example, when the employer's contribution is automatically invested in the company stock fund, but the participant has the ability, at any time, to transfer funds out of the company stock fund, the stock fund may be considered participant directed. For separately managed accounts, even though the participant does not direct the investment of the underlying investments of the separately managed account, those underlying investments are considered participant directed because the participant selected to participate in the separately managed account.

D. Non-participant-directed investments

If the plan offers non-participant-directed investment options in addition to the participant-directed investments, then the plan is required to disclose information about the non-participant-directed investments either on the face of the statement or in the notes. Non-participant-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.

II. Common types of investments in a 401(k)

The following information is important to auditors of both full and ERISA limited-scope audit engagements. While we are not going to examine the actual audit procedures, we are going to define and explain the investment options in detail as well as common situations auditors encounter throughout the auditing process.

A. Registered investment companies (mutual funds)

Registered investment companies, commonly referred to as mutual funds, are probably the most popular investment choice for defined contribution plans. The registered investment company must be registered with the SEC, must be governed by a board of directors or board of trustees, and must be managed by a registered investment advisor.

Most auditors are familiar with the basic concept of a mutual fund, but a basic understanding is not always sufficient to properly audit and/or disclose information related to investments in a defined contribution plan. There is not an actual legal definition for a mutual fund, but the term is most commonly applied only to those collective investment schemes that are regulated, available to the general public, and open-ended in nature.

There are some advantages to investing in a mutual fund versus an individual security. These advantages include:

- Increased diversification;
- Daily liquidity and valuation;
- Professional investment management;
- Ability to participate in investments that may be available only to larger investors;
- Government oversight; and
- Ease of comparison.

However, there are disadvantages to investing in mutual funds as well, which include:

- Fees;
- Less control over timing of recognition of gains;
- Less predictable income; and
- Lack of opportunity to customize.

B. Collective trusts

Since 1927, collective trust funds (CTFs; sometimes known as Collective Investment Trust Funds (CTFs)) have been a valued and respected investment vehicle within the retirement plan community. The popularity of the collective trust fund has ebbed and flowed over the years as plan sponsors seek the lowest cost and most effective investment options for their retirement plan. Today, market trends show that CTFs are more active and diverse than many other retirement vehicles. Given this fact, there have been significant changes in the mix of funds used by plan sponsors. A collective trust is an investment fund that is established by institutional investors such as banks, financial institutions, or trust companies. In general, these institutional investors will create a collective trust for the purpose of gaining economies of scale by investing a large amount of resources, which are the result of combining the investments made by numerous entities like employee benefit plans. Due to the fact that individual retirement plans may not have enough resources on their own to engage in certain financial transactions, a collective trust may be an alternative. A collective trust allows individual plans to combine their purchasing power and engage in financial transactions that would not be feasible otherwise. In the past, the term “common/collective trust” (CCT) has been used to describe these types of investments. The investment itself is either a common trust or a collective trust fund. Health and welfare plans cannot be invested in a collective trust fund. 401(k) and defined benefit plans would not normally invest in common funds. While the term CCT may still be used to refer to common/collective trust funds, the correct terminology is the collective trust fund (CTF).

A CTF may be used to invest some or all of a plan's assets. A plan generally acquires investment units, referred to as units of participation, representing an undivided interest in the underlying assets of the trust. The purchase or redemption price of the units is determined periodically by the trust based on the current market values of the underlying assets of the fund.

Participating in a collective trust may result in larger returns for the participating institutions, which in turn will benefit the client base for each institutional investor.

Benefits associated with being a part of a collective trust include:

- Execution of investment orders;
- The process of executing investment orders is simplified due to the combination of institutional investors. There is only one order from the combined group instead of numerous orders from individual investors;
- Enhanced investment opportunities;
- The collective trust makes it possible to engage in larger financial transactions which then increase the chances for a higher return;
- Less protective regulations than other investors; and
- The perception for a collective trust is that the pool of institutional investors has a combination of resources and knowledge necessary to protect their best interests.

While a collective trust may look similar to a mutual fund, there are differences. One such difference is that a collective trust does not have a ticker symbol. The auditor will not be able to locate the market value of a collective trust on any exchange because they are not regulated by the SEC. Instead, the collective trusts are overseen by banking regulators and enforced by the Office of the Comptroller of Currency. The trust must be valued quarterly unless the trust holds fewer liquid assets, and then it can be valued annually.

Auditors should understand how the investment purchases and sales are accounted for within the trust, including how the capital gains and losses are passed through to the participants. In a full-scope audit, the auditor will test the end of year value of the trust along with the increases and decreases in trust activity. CTFs are often valued at net asset value (NAV) of shares of a bank collective trust held by the plan at year-end. The NAV is typically based on the fair value of the underlying investment held by the fund. A copy of the audited financial statements of the CTF may be obtained by the plan sponsor from the investment manager. The audited financial statements will assist the plan auditor in determining the audited unit value of the fund that may be combined with confirmed units held to determine fair value.

C. Stable value funds

One of the more common CTF investment objectives is a stable value fund (SVF).

Stable value funds are capital preservation investment options available in 401(k) plans and other types of savings plans. They are invested in a high quality, diversified fixed income portfolio that are protected against interest rate volatility by contracts from banks and insurance companies. Stable value funds are designed to preserve capital while providing steady, positive returns. Stable value funds are considered a conservative and low risk investment compared to other investments offered in 401(k) plans.

Stable value funds are often made available in these plans under a name that intends to describe the nature of the fund (such as capital preservation fund, fixed-interest fund, capital accumulation fund, principal protection fund, guaranteed fund, preservation fund, or income fund among others). They offer principal preservation, predictable returns, and a rate higher than similar options without proportionately increasing risk. The funds are structured in various ways, but in general they are composed of high quality, diversified fixed income portfolios that are protected against interest rate volatility by contracts from banks and insurance companies.

Stable value funds are structured in two ways: as a separately managed account, which is a stable value fund managed for one specific 401(k) plan; or as a commingled fund, which pools together assets from many 401(k) plans. Commingled funds offer the benefits of diversification and economies of scale for smaller plans.

Regardless of how stable value funds are structured, they are comprised of a diversified portfolio of fixed income securities that are insulated from interest rate movements by contracts from banks and insurance companies. The protection from interest rate volatility is universal to stable value funds. How this contract protection is delivered depends on the type of stable value fund investment purchased. The contract protection against interest rate volatility is provided through the following investment instruments:

- A Guaranteed Interest Contract (GIC) is a contract with an insurance company that provides principal preservation and a specified rate of return over a set period of time, regardless of the performance of the underlying invested assets. The invested assets are owned by the insurance company and held within the insurer's general account.
- A separate account contract is an account held by an insurance company that holds a combination of fixed income securities and provides principal preservation and a specified rate of return over a set period of time. Separate accounts may provide either a fixed rate of return or a periodic rate of return based on the performance of the underlying assets. The assets are owned by the insurance company and are set aside in a separate account solely for the benefit of the specific contract holder.
- A synthetic GIC is a diversified portfolio of fixed income securities that are insulated from interest rate volatility by contracts (wraps) from banks and insurance companies. In this arrangement, the 401(k) plan and its participants own the underlying invested assets-the portfolio of fixed income securities that support the stable value fund.

Note:

Auditors should remember that investments in stable value funds are not considered to be a direct investment in a guaranteed investment contract that would be required to be measured at contract value on the statement of net assets available for benefits. Instead, the stable value investments should be reported at fair value in a manner similar to other CCTs.

D. Self-directed brokerage accounts

A self-directed brokerage account (SDBA) provides participants the opportunity to invest all or a portion of their defined contribution plan account balance into investment options available through the brokerage service that are not otherwise available under the plan. The investment options may include stocks, bonds, mutual funds, limited partnerships, and private equity investments.

There are advantages for the plan sponsor that include:

- Investment flexibility for participants that are knowledgeable about investments; and
- Customization of the types of investments available to the participants or limiting the allocation.

Participant advantages include:

- Investment opportunities that are not otherwise available under the plan;
- Online trading and investment research tools create flexibility and control; and
- Access to retirement brokerage specialists familiar with retirement plans, brokerage services, and the provisions of a plan sponsor's specific plan.

In ERISA limited-scope situations, auditors should determine whether or not the SDBA is covered by the certification. It is not uncommon for the SDBA to be excluded from the certification due to the nature of the account. Therefore, the SDBA would be subject to full-scope audit procedures. Another factor is

whether the SDBAs are addressed by the service organization control report (Type 2 SOC 1 report) and if so, the extent of testing may be reduced.

E. Insurance products

The various investment options offered by insurance companies are probably one of the most confusing parts for plan auditors. One reason is that insurance companies offer a number of different products that provide funding, insurance, and services to employee benefit plans.

A plan may invest assets with an insurance entity pursuant to a number of different types of contracts. The amounts remitted to an insurance entity become the assets of the insurance entity for which it, in turn, assumes an obligation to fulfill the contract terms. For employee benefit plans, the fundamental basis of distinction in classifying contracts for accounting purposes is:

- Whether the contributions are currently used to purchase insurance or annuities for the individual participants; or
- Whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right.

The auditor should obtain a copy of the contract issued by the insurance company because most insurance products are typically established pursuant to a contract. The terms of the contract with the insurance company will define the extent to which the assets and transactions related to the insurance arrangements are recorded in the plan's financial statements.

The contracts may be referred to as insurance contracts or investment contracts, depending on the contract terms. The contract and supporting documentation provide information for determining the appropriate accounting classifications and financial reporting of the contract. For example, an insurance contract is one that subjects the insurer to significant insurance risks. These risks include, but are not limited to, the mortality or morbidity of plan participants. Insurance contracts usually have an interest rate guarantee or investment performance risk.

On the other hand, investment contracts do not have substantial mortality or morbidity (or similar) risks. Instead, many investment contracts have features that are similar to financial or investment products offered by other types of financial institutions.

Just to make matters a little more confusing, the defined contribution plan may be offered a wide variety of insurance product options by a single insurance company. Auditors should be aware that while many contracts may appear similar, they can have very different terms. These differences include:

- Different restrictions on the transfer of the funds among various parts of the contract;
- The ability to terminate; or
- The ability to renew the contract.

For example, the plan and the participants in certain guaranteed annuity contracts may be restricted from withdrawing or transferring all or part of the contract value immediately. They may also be charged a withdrawal fee or restricted in some other manner. The reason for the contract provisions is to mitigate certain risks including large-scale withdrawal risks that could be detrimental to the insurance company and remaining contract holders.

Contractual arrangements under which funds are currently allocated to purchase insurance or annuities for individual participants are referred to as allocated funding arrangements, whereas other arrangements are called unallocated funding arrangements. Funds in an unallocated contract may be withdrawn or otherwise invested.

Note:

Allocated contracts are excluded from plan assets. The DOL issued Advisory Opinion No. 2010-01A, that concluded that an annuity contract is not an allocated contract regardless of the method of benefit distribution because the contract does not guarantee a benefit of a specified amount of receipt of each contribution.

Allocated funding arrangements include annuity contracts which are irrevocable and involve the transfer of significant risk from the employer to the insurance entity. **Allocated contracts should not be included in the plan's financial statements.**

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

1. Separate accounts

In accordance with the audit and accounting guide for employee benefit plans, separate accounts were developed to allow insured plans to compete with trust funds in making investments and in funding variable annuity plans. The assets of a separate account plan are assets of the insurance entity but are not commingled with the insurance entity's general assets. The purpose of a separate account is to provide flexibility in the investment of the plan's funds. A separate account may be established solely for one plan or, more commonly, may be pooled with the funds of several plans.

A separate account in which only one plan participates is generally referred to as an **individual separate account** or as a **separate-separate account**. The investments in the account must be separately identified, and the account is operated similarly to a bank trust fund, although it is included in the insurance entity's financial statements.

A separate account in which several plans participate generally is referred to as a **pooled separate account (PSA)**. A PSA is maintained by an insurance carrier, which is regulated, supervised, and subject to periodic examination by a state agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of controlled group of corporations. PSAs are similar to mutual funds except that they are issued by insurance companies and are not publicly traded like mutual funds. Each plan's share of a PSA is determined on a participation-unit or variable-unit basis. The plan's equity account provides a cumulative record of the number of participation units credited to the account and the number of units allocated or withdrawn from the account. The balance of participation units credited to the account, multiplied by the current participation-unit value, equals the amount of equity account assets held on behalf of the policyholder at any given time. The participation-unit value is adjusted periodically, usually each business day, to reflect investment results under the separate account. PSAs often have audited financial statements; however, for certain insurance companies, audited PSA financial statements are not available.

2. *Guaranteed investment contract*

One of the most common types of insurance products is a guaranteed investment contract (GIC), which is a contract that guarantees repayment of principal and a fixed or floating interest rate for a predetermined period of time. The investments in the GIC are selected for their ability to provide safety of principal and guaranteed rates of return. The most typical GIC is a zero-coupon instrument which offers a guaranteed or predetermined rate of interest applied to all funds under the contract. The accumulated value is paid at maturity. In this traditional contract, the issuer assumes all of the credit and interest rate risks on the assets used to back the annuity contract and the market value risk on any participant withdrawals. Although GICs originated as a defined benefit plan investment, most today are issued to defined contribution plans, where they offer plan participants the ability to withdraw their funds (subject to plan rules) for benefits or transfers to other plan options at contract value. The life company underwrites the market value risk on this popular withdrawal feature.

GICs are offered by an insurance company or other entity. The contributions are invested in the general assets of an insurance company. It provides a stated (guaranteed) rate of return and has a set maturity date.

Variations include contracts in which the plan is permitted to make deposits or withdrawals during certain windows during the contract life, contracts with multiple maturities (and rates), contracts in which the insurance entity guarantees a minimum rate and may credit the contract holder with additional interest, and contracts with floating rates. These contracts are unallocated and are generally to be included as plan assets at their contract value or fair values, as appropriate.

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:
 - 1. The repayment of the principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract.
 - 2. 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:
 - 1. Withdrawals for benefits.
 - 2. Loans.
 - 3. 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:
 - 1. Premature termination of contracts by the plan.
 - 2. Plant closings.
 - 3. Layoffs.
 - 4. Plan termination.
 - 5. Bankruptcy.
 - 6. Mergers.
 - 7. Early retirement incentives.
- e. The plan must allow participant reasonable access to their funds.

As stated in the FASB ASC glossary, if access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive.

Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-rate investment options to limit arbitrage among those investment options (equity wash provisions) would not affect a contract's benefit responsiveness.

According to FASB ASC 962-325-35-9, if a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. FASB ASC 962-325-35-10 states contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

3. Synthetic guaranteed investment contracts

A synthetic guaranteed investment contract (GIC) is a variation of a traditional GIC. It is an investment contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the plan owns the underlying assets of the synthetic GIC. With a traditional GIC, the plan owns only the investment contract itself that provides the plan with a call on the contract issuer's assets in the event of default. The underlying assets of the synthetic GIC may be held in a trust owned by the plan and typically consist of government securities, private and public mortgage-backed and other asset-backed securities, and investment grade corporate obligations. To enable the plan to realize a specific known value for the assets if it needs to liquidate them to make benefit payments, synthetic GICs utilize a benefit-responsive wrapper contract issued by a third party that provides market and cash flow risk protection to the plan. (The third-party issuer of the wrapper is an entity other than the plan sponsor, administrator, or trustee and, in certain situations, may be the entity that issues the investment contract.)

4. Valuation

FASB ASC 962, *Plan Accounting, Defined Contribution Pension Plans*; and FASB ASC 965, *Plan Accounting, Health and Welfare Plans*, require fully benefit-responsive contracts to be measured at contract value. Those topics also require an adjustment to reconcile contract value to fair value, when these measures differ, on the face of the plan financial statements. Fair value is measured using the requirements in FASB ASC 820, *Fair Value Measurement*. Contract value is the amount that a participant would receive if he or she were to initiate transactions, such as make a withdrawal from the contract, and represents the accumulated contributions plus accrued net investment income less withdrawals and expenses.

In accordance with Part I of FASB ASU No. 2015-12, *Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient*, fully benefit-responsive investment contracts that are measured at contract value should be presented at contract value on the statement of net assets available for benefits. The changes in presentation related to fully benefit-responsive investment contracts is effective for fiscal years beginning after December 15, 2015, with early application permitted.

Note:

Fully benefit-responsive investment contracts as defined by the FASB ASC glossary, is limited to direct investments between the plan and the issuer. Plans may indirectly hold fully benefit-responsive investment contracts through beneficial ownership of CCTs (which own investment contracts). Insurance company PSAs that hold investment contracts also have similar characteristics. When CCTs and PSAs hold fully benefit-responsive investment contracts, the plan's investment in the CCT or PSA are not considered fully benefit-responsive investment contracts and should be reported at fair value.

Disclosures in accordance with adoption of FASB ASU No. 2015-12 are as follows:

- Description of the nature of the investment contract.
- Description of an event that would limit the ability of the plan to transact at contract value with the issuer including a statement that the occurrence of each of those events would limit the ability of the plan to transact at contract value with the participants in the plan is not probable of occurring. The following are examples of events that may limit the plan's ability to transact at contract value:
 - Premature termination of contracts by the plan.
 - Plant closings.
 - Layoffs.
 - Plan termination.
 - Bankruptcy.
 - Mergers.
 - Early retirement incentives.
- Description of events and circumstances that would allow issuers to terminate fully benefit-responsive contracts with the plan and settle at an amount different from contract value.
- The total contract value for each type of investment contract (for example, synthetic investment contracts or traditional investment contracts).

F. Hard-to-value investments

Depending on the nature of the plan, the employer, and the participants, plan investments may include hard-to-value investment, such as real estate, limited partnerships, private equity funds, derivatives, and the like. 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. However, the hard-to-value investments may offer greater flexibility in investing strategies than registered investment companies. These investments may be held by participants as part of their SDBAs, or in a profit-sharing plan in funds that are non-participant-directed and based on an asset allocation determined by the advisors of the plan sponsor. It is unusual for a participant-directed defined contribution plan to have as an investment option a hard-to-value investment, because of the need for daily valuation of the plan to allow participants to receive distributions and transfer funds from one investment option to another at their discretion, without having to wait for cumbersome valuation procedures to be performed.

Understanding how the hard-to-value investments are valued may be difficult for auditors and require the use of a specialist. Before a specialist is considered, the auditor should understand the investment itself and how it works. For example, a private equity fund includes venture capital investment companies or partnerships, limited partnerships, and other start-up ventures. The private equity fund typically is evidenced by a written agreement, which allows for call commitments and withdrawal restrictions. The companies which these funds invest in may be in the research and development stage, which are not currently producing revenue.

On the other hand, hedge funds are similar to mutual funds but are allowed to use aggressive strategies typically not found in mutual funds, including selling short (such as leveraging), and extensive use of derivatives. In the case of hedge funds, the auditor may not be able to obtain audited financial statements; and determining the underlying investments may be difficult.

Hard-to-value investments may be valued in accordance with the market approach, which uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Another valuation method is the income approach, which uses valuation techniques to convert future amounts, such as cash flows, to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.

Finally, the cost approach may be utilized by some investments, such as venture capital funds and limited partnerships, valued at the total dollar invested in the project. In many of these cases, these investments involve start-up companies that are not marketable. In these situations, there may not be a basis for fair value; the historical cost is oftentimes the most attainable. Even though the cost method may be used to value the hard-to-value investment, it is not acceptable for an employee benefit plan financial statement report.

G. Master trusts

A master trust is a trust account made up of assets of some or all of the employee benefit plans of a company that sponsors more than one plan or a group of corporations under common control. Typically, each plan has an undivided interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation. However, for certain DC plans, master trust arrangements exist whereby the investment in the master trust represents a specific interest in certain investments and possibly participant loans and, therefore, do not represent an undivided interest.

FASB ASU No. 2017-06, *Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): Employee Benefit Plan Master Trust Reporting (a consensus of the Emerging Issues Task Force)*, relates primarily to the reporting by a plan for its interest in a master trust. The amendments in this Update are effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. An entity should apply the amendments in this Update retrospectively to each period for which financial statements are presented.

The main provisions of the Update are as follows:

- For each master trust in which a plan holds an interest, the plan's interest in that master trust and any change in that interest must be presented in separate line items in the statement of net assets available for benefits, and in the statement of changes in net assets available for benefits, respectively.
- Plans with divided interests are no longer required to disclose the percentage interest in the master trust. Instead, all plans are required to disclose the dollar amount of their interest in each of those general types of investments. This supplements the existing requirement to disclose the master trust's balances in each general type of investment.
- All plans are required to disclose: (1) Their master trust's other asset and liability balances (e.g., amounts due to brokers for securities purchased, accrued interest and dividends, and accrued expenses); and (2) The dollar amount of the plan's interest in each of those balances.

- To avoid redundancy, required investment disclosures relating to 401(h) account assets are no longer required to be included in the health and welfare benefit plan financial statements. The health and welfare benefit plan is only required to disclose the name of the defined benefit pension plan in which those investment disclosures are provided. This is so that participants can easily access those statements for information about the 401(h) account assets, if needed.

1. Illustration for a divided interest in a master trust

	Master Trust Balances	Plan's Interest in Master Trust Balances
Mutual funds	\$ 13,560,000	\$ 6,816,800
Common stocks	2,245,000	1,638,200
U.S. government securities	575,000	
Corporate bonds	327,500	
Total assets	<u>16,707,500</u>	<u>8,455,000</u>
Plus:		
Due from broker for securities sold	225,000	100,000
Accrued interest and dividends	125,000	50,000
Less:		
Due to broker for securities purchased	(95,000)	(50,000)
Accrued expenses	(30,000)	(15,000)
Total	<u>\$ 16,932,500</u>	<u>\$ 8,540,000</u>

2. Illustration for an undivided interest in a master trust

	Master Trust Balances	Plan's Interest in Master Trust Balances
Mutual funds	\$ 13,560,000	\$ 6,780,000
Common stocks	2,245,000	1,122,500
U.S. government securities	575,000	287,500
Corporate bonds	327,500	163,750
Total assets	16,707,500	8,353,750
Plus:		
Due from broker for securities sold	225,000	112,500
Accrued interest and dividends	125,000	62,500
Less:		
Due to broker for securities purchased	(95,000)	(47,500)
Accrued expenses	(30,000)	(15,000)
Total	\$ 16,932,500	\$ 8,466,250

III. Direct filing entity

Some plans participate in certain trust accounts and other investment arrangements that file Form 5500 as a direct filing entity (DFE). There are certain types of entities that may be considered a DFE, including common collective trusts, pooled separate accounts, master trusts, and 103-12 entities. In order to be classified as a DFE, the entity must file its own Form 5500. If the issuer of the pooled investments does not file as a DFE with the DOL, then the plan must present its portion of each of the underlying investments by appropriate investment classification on the Schedule H of the plan's Form 5500. If the plan does not list this detail, then the DOL may consider the plan's Form 5500 filing incomplete and reject the filing. If the plan does have an investment in a DFE, then the plan may utilize single line-item reporting on the Schedule H of Form 5500 such as investment in CCT/PSA. The Form 5500 for the plan should also include a Schedule D for the DFE. The plan sponsor should make inquiries with the investment issuer to determine the DFE filing status.

Due to the nature of the various investment options available to plans, it is imperative that auditors obtain a detailed understanding of the plan's assets. There is a risk that investments may be measured, presented, and disclosed incorrectly on the financial statements and Form 5500.

One common scenario is when a plan has investments with an insurance company. Oftentimes, insurance company offerings appear to be mutual funds available for the participants to select for investment purposes. In reality, these types of investments are separate accounts and subject to different valuation and disclosure requirements. Therefore, the auditor should obtain copies of the contract with the insurance company to ensure that the investments are presented properly on the financial statements and Form 5500. The auditor may also find it helpful to search for the DFE's Form 5500 filing through the efast2 website.

Unfortunately, the plan sponsor may not be able to provide clarification regarding the nature of the investments held by the plan. The auditor should carefully consider whether this should be identified as a deficiency in internal control.

IV. Fair value measurements

Investments must be reported at fair value on the financial statements. In an attempt to assist plan sponsors in understanding how the investments are valued, FASB ASC 820, *Fair Value Measurement*, was issued. In accordance with FASB ASC 820, a framework for measuring fair value was established; and fair value is defined 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.

The framework 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 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy 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. Examples include common stocks and mutual funds that are actively traded.
- Level 2 inputs to the valuation methodology include:
 - Quoted prices for similar assets or liabilities in active markets.
 - Quoted prices for identical or similar assets or liabilities in inactive markets.
 - Inputs other than quoted prices that are observable for the asset or liability.
 - 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.
 - Examples include collective trusts, pooled separate accounts, common stocks that are not actively traded, etc.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Examples include guaranteed investment contracts, stable value funds, real estate, derivatives, etc.

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 used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The following is an example of a description of the valuation methodologies used for assets measured at fair value:

- **Common stocks** – Valued at the closing price reported on the active market on which the individual securities are traded.
- **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 and to transact at that price. The mutual funds held by the plan are deemed to be actively traded.

- **Hedge fund and real estate fund** – Valued at net asset value (NAV) of units held. The NAV 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 liability. 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.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the plan believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Discussion question:

Do you have plans that classify CCTs and PSAs as being valued at NAV as a practical expedient?

A. Examples

1. NAV as a practical expedient

The following example emphasizes investments that are valued at NAV as a practical expedient.

The following table sets forth by level, within the fair value hierarchy, the Plan's investment assets at fair value as of December 31, 20X5 and 20X4:

Investment 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 in the fair value hierarchy	\$5,422,500	\$532,500	\$20,000	\$5,975,000
Investments measured at net asset value (a)				\$1,422,000
Investments at fair value	\$5,422,500	\$532,500	\$20,000	\$7,397,000

Investment 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 in the fair value hierarchy	\$4,520,000	\$375,000	\$19,000	\$4,914,000
Investments measured at net asset value (a)				\$2,100,000
Investments at fair value	\$4,520,000	\$375,000	\$19,000	\$7,014,000

(a) In accordance with FASB ASC 820-10, certain investments that were measured at net asset value per share (or its equivalent) have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented in the statement of net assets available for benefits.

	Level 3 Assets Year Ended December 31, 20X5
Balance, beginning of year	\$19,000
Realized gains/losses	500
Unrealized gains/losses relating to instruments still held at reporting date	2,000
Purchases	—
Sales	(1,500)
Transfers in and/or out of level 3	—
Balance, end of year	\$20,000
The amount of total gains or losses for the period attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$2,000

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, 20X2.

As of December 31, 20X2, 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%

Disclosures relating to fair value measurements of investments in certain entities that calculate nav per share (or its equivalent) – FASB ASC 820-10-50-6A requires disclosures for each class of investment about the attributes of investments within the scope of paragraphs 4-5 of FASB ASC 820-10-15, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. These disclosures are required for all investments within the scope of paragraphs 4-5 of FASB ASC 820-10-15 and that are measured using the practical expedient in FASB ASC 820-10-35-59 on a recurring or non-recurring basis during the period.

In accordance with FASB ASC 820-10-35-54B, an investment within the scope of paragraphs 4-5 of FASB ASC 820-10-15 for which fair value is measured using NAV per share (or its equivalent) as a practical expedient should not be categorized within the fair value hierarchy. Although the investment is not categorized within the fair value hierarchy, a reporting entity should provide the amount measured using the NAV per share (or its equivalent) practical expedient to permit reconciliation of the fair value of

investments included in the fair value hierarchy to the line items presented in the statement of net assets available for benefits.

The following table summarizes investments measured at fair value based on net asset value (NAVs) per share as of December 31, 20X5 and 20X4, respectively. This table would be required if CCT is measured at NAV as a practical expedient.

December 31, 20X2	Fair Value	Unfunded Commitments	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Common collective trust (a)	\$2,100,000	–	Monthly	30 days

2. NAV as a readily determinable fair value

The following example emphasizes investments that are valued at NAV as a readily determinable fair value and assumes the Plan has adopted FASB ASU No. 2015-07.

The following table sets forth by level, within the fair value hierarchy, the Plan's investment assets at fair value as of December 31, 20X5 and 20X4.

Investment 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
Common collective trust		\$1,422,000		\$1,422,000
Corporate bonds		\$307,500	\$20,000	\$327,500
Investments at fair value	\$5,422,500	\$1,954,500	\$20,000	\$7,397,000

Investment 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
Common collective trust		\$2,100,000		\$2,100,000
Corporate bonds		\$255,000	\$19,000	\$274,000
Investments at fair value	\$4,520,000	\$2,475,000	\$19,000	\$7,014,000

Efficient and Effective Audit Procedures

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Efficient and Effective Audit Procedures

Learning objectives

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

- Understand the required audit procedures related to key audit areas;
- Identify and understand the different types of investments that may be offered in the 401(k) plan; and
- Discuss best practices and common audit pitfalls associated with 401(k) plans.

I. Introduction

In this chapter we will review several difficult audit areas and situations that auditors may encounter during an audit engagement. Investments are typically the most significant asset on the financial statements, and it is important that auditors understand the types of investments held by the plan. Contributions, participant data, and distributions are required to be tested regardless of the scope of the audit. While the overall audit approach for each of these areas may be relatively straightforward, there are other times when auditors receive conflicting documentation and information. Compliance issues associated with eligibility and enrollments, payroll and compensation, participant loans, and other audit areas will be discussed in this chapter in order to identify what can go wrong and best practices. The conflicts and questions must be identified and then resolved.

II. Sampling process

At this point of the employee benefit plan audit engagement, the auditor should have completed the initial planning of the overall audit strategy based on their understanding of the plan, its environment, and related controls, and completed the risk assessment in order to determine audit procedures.

Auditors usually begin the testing phase by selecting a sample of participants to test for eligibility. The size of the sample may be determined based on the dollar value of the plan assets; total number of employees of the plan sponsor and the number of participants in the plan; defined percentage according to the firm's QC documents; or other defined parameters including the auditor's own professional judgment. Sample sizes vary from one engagement to the next and between different auditors. The most important thing to remember is that documentation is essential!

Sampling in an employee benefit plan engagement usually only applies to a few key audit areas. These areas include participant demographics, eligibility, payroll, and contributions. For other audit areas, such as participant loans and distributions, the auditor usually selects loans and distributions based on some other criteria other than sampling.

At a minimum, auditors should document the following when it comes to sampling:

- How the sample size was determined;
- Population from which sample will be selected and if it was complete;
- The selection method (haphazard, random, systematic, or judgmental);
- What constitutes a deviation; and
- Results of procedures applied to sample selection.

The process of sample selection includes determining whether or not the population from which the items are being selected is complete. Determining completeness in an employee benefit plan audit involves determining if current and terminated or retired employees have been included in the population.

Discussion question:

Would the payroll report by itself be considered a complete population? What about employees that terminated or retired in previous years that still have account balances?

Note:

A best practice for many auditors is to obtain the detailed payroll report for the plan year that shows total wages paid, employee contributions withheld, and the employer match for all current and terminated employees. In addition to the payroll report, the auditor should also obtain the participant allocation report from the service organization. The allocation report will show all participants with account balances in the plan, the opening balance for the year, contributions, distributions, earnings, gains and losses for the year, and the ending balance. A combination of the payroll report and the allocation report will typically provide the auditor with a complete population for sample selection purposes.

For efficiency, many auditors will utilize the same sample selection to test participant eligibility, payroll, and contributions.

Issues identified in an employee benefit plan audit associated with sampling include:

- Inappropriate sample size (such as 1);
- Insufficient documentation on how sample was determined; and
- Incomplete population.

Sampling may not be applicable to all audit areas of the employee benefit plan engagement. For example, sampling may not be appropriate for testing participant loans and distributions from the plan. For distribution and participant loan testing, the auditor is typically going to use professional judgment in regard to which participants to select for testing.

III. Electronic environment considerations

Due to the changes in technology, many service organizations provide plan sponsors and participants with the ability to enroll online, make changes electronically, and access current and historical information. Therefore, auditors may not be able to obtain hard copies of enrollment forms or participant loan forms, or distribution forms. Auditors should be able to design alternative procedures in order to test participant data and other audit areas.

Due to the advances in technology, many participants are able to initiate and complete numerous transactions over the telephone or the Internet. Many service organizations are offering plans and participants a secure portal through which a participant can:

- Make changes to their account;
- Request a distribution;
- Make changes in investment allocations;
- Make changes in deferral percentages; and
- Request a loan.

Therefore, auditors should design procedures to test electronically initiated transactions for which there is no paper trail.

IV. Participant data and allocations

The types of participant data that are tested in an audit of a 401(k) plan's financial statements will vary from plan to plan, depending on the factors on which contributions, participant elections, participant allocations, and benefits are determined. In general, the data tested may include:

- Demographic data, birth date, marital status, date of hire, date of termination, and other demographic data that determine eligibility and vesting.
- Payroll data, such as hours worked, earnings, and contributions to the plan.
- Benefit data for participants receiving benefits, such as benefit levels and benefit options selected.
- Participant elections for salary deferral percentage and investment elections.

Prior to applying procedures to contributions, distributions, and other audit areas, auditors should first determine who is eligible to participate in the plan. Eligibility requirements will be defined in the plan document. Auditors will need to obtain a copy of the plan document from the plan administrator in order to complete their testing and make sure that the plan is operating in accordance with the plan document and rules and regulations of ERISA.

Recurring issues noted by DOL and peer reviewers related to participant eligibility and data include the following:

- a. The assumption that no audit procedures need to be performed in an ERISA §103(a)(3)(C) audit. Performing such audits only eliminates procedures over certified investments but other transactions and balances must be audited as is stated in the auditor's report.
- b. Overreliance on the service auditor's report. Relying on the SOC reports allows the auditor to reduce substantive testing over covered areas, not eliminate testing.
- c. Testing of payroll data is insufficient. Auditor did not perform procedures on an adequate sample size; did not agree rate of pay to authorization; did not reconcile changes in compensation during the year; did not agree to definition of compensation per plan document; failure to test payroll data on multi-employer plans
- d. No testing of participant eligibility or forfeitures. Due to overreliance on certification and Type 2 SOC 1 report; did not understand plan document or test eligibility in accordance with plan document.
- e. No testing of investment income allocation to participants. Usually as a result of overreliance on certification and Type 2 SOC 1 report or not understanding the audit requirements.
- f. GAAS requires auditors to test allocation of total net assets to participant accounts. Lack of proper documentation showing the reconciliation between total net assets and the allocation report.

Auditors should comply with the stated audit object for each audit area. The audit objectives for participant data and asset allocation are to provide the auditor with a reasonable basis for establishing:

- Whether all covered employees have been properly included in employee eligibility records and, if applicable, in contribution reports;
- Whether accurate participant data for eligible employees was supplied to the plan administrator and, if appropriate, to the plan service organizations;
- The accuracy of the allocation of net assets to the individual participant accounts in accordance with the plan document;
- The completeness and valuation of participant accounts (including forfeiture account), in total;
- Proper authorization of participant transactions and the accuracy that such transactions have been executed at the proper amount, in the proper period, and in accordance with the plan document and participant's direction;
- Net assets have been allocated in accordance with the plan document to the individual participant accounts;
- The sum of the participant accounts reconciles with the total net assets available for benefits; and
- Participant transactions are authorized and executed in the proper period for the proper amount.

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 §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.

Many auditors approach testing participant data in similar fashions. After the sample has been selected and the plan administrator has pulled the personnel files, the auditor will examine the information included in the personnel records. Information such as the following should be examined to assist the auditor in determining eligibility and verifying participant data:

- Driver's license;
- Social Security Number;
- A Form I-9, *Employment Eligibility Verification*;
- Personnel action form noting date of hire;
- 401(k) enrollment form; and
- Other items as considered necessary by the auditor.

These items are an integral part of testing participant data. The auditor examines these items to determine eligibility to participate and vesting based on demographic data (birth date, date of hire, and various other factors).

A couple of issues associated with participant data include incomplete personnel files and electronic enrollments. Auditors will often encounter situations where the plan sponsor does not have any type of documentation to support that the plan was offered to all eligible employees.

Relevant assertions related to participant data and allocations include the following:

- The accuracy of the allocation of net assets to the individual participant accounts in accordance with the plan document.
- The completeness and valuation of participant accounts (including the forfeiture account) in total.
- The authorization of participant transactions and the accuracy that such transactions have been executed at the proper amount, in the proper period, and in accordance with the plan document and participant's direction.

Discussion question:

What happens in the event that the auditor encounters one of the following scenarios?

1. Participant investment options or salary deferral amounts may not be in accordance with their stated elections.
2. Allocations of income or expenses may be inaccurate, causing the participant's account to be overstated or understated.
3. Lack of reconciliations or improperly prepared reconciliations by management could result in missing contributions or improper allocations.
4. Employees not appropriately included or excluded from participating based on the plan's provisions.
5. Employee and employer contributions are incorrect due to the use of a definition of compensation different from the plan's provisions.
6. Incorrect compensation or hours is used to determine compensation.

If the auditor has identified any of the situations noted above, then the appropriate corrections must be made. The corrections that may be necessary to correct operational and compliance deficiencies will vary from plan to plan and will depend on the nature of the actual deficiency identified.

1. **Participant investment options or salary deferral amounts may not be in accordance with their stated elections.**

The auditor should communicate the differences to the plan administrator; the plan administrator will then be responsible for making the necessary corrections in order to make the participants 100 percent whole. It may be necessary for the plan sponsor to make a corrective contribution or reallocation or distribution for the differences. The auditor should determine and document the internal controls that were missing or deficient and communicate to those charged with governance.

2. **Allocations of income or expenses may be inaccurate, causing the participant's account to be overstated or understated.**

The auditor should determine what the appropriate allocation formula is based on the plan document provisions. In this scenario it may also be necessary for the plan sponsor to make a corrective contribution or reallocation or distribution for the differences. Misallocations of income or expense should also be identified as a deficiency in internal control and communicated accordingly.

3. **Lack of reconciliations or improperly prepared reconciliations by management could result in missing contributions or improper allocations.**

The auditor should communicate with the plan sponsor the importance of timely reconciliations in order to identify missing or improper or inaccurate allocations. Due to the nature of employee benefit plan, a significant portion of the plan's operations and administration occurs at service providers. Therefore, it is critical that plan sponsors regularly monitor all service providers to the plan.

4. **Employees not appropriately included or excluded from participating based on the plan's provisions.**

The auditor should advise the plan sponsor to make a qualified nonelective contribution for the employee that compensates for the missed deferral opportunity.

Due to the fact that the next two scenarios involve the definition of compensation, they have been grouped together for discussion purposes.

5. **Employee and employer contributions are incorrect due to the use of a definition of compensation different from the plan's provisions.**

6. **Incorrect compensation or hours is used to determine compensation.**

Because the plan may use different definitions of compensation for different purposes, it is important that the plan apply the proper definition for deferrals, allocations, and testing. A plan's compensation definition must satisfy rules for determining the amount of contributions.

The plan sponsor must follow the plan document compensation definitions. Compensation generally includes the pay a participant received from the employer for personal services for a year, including:

- Wages and salaries;
- Fees for professional services;
- Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to:
 - Commissions and tips;
 - Fringe benefits; and
 - Bonuses.

The plan's terms may include all or a portion of compensation for purposes of determining an employee's allocation or salary reduction contribution. In addition, the plan may need to ensure that compensation used for testing complies with applicable statutes.

In these scenarios, the auditor should advise the plan sponsor that a corrective contribution, reallocation, or distribution needs to be made in order to correct the discrepancy.

It is critical that the plan monitor its operation to ensure that the terms of the plan are followed to determine an employee's elective deferral or other allocation. In addition, it is critical to monitor the plan to ensure that the compensation used for different testing purposes.

V. Automatic enrollments

Automatic enrollment allows an employer to automatically deduct elective deferrals from an employee's wages unless the employee makes an election not to contribute or to contribute a different amount. Any plan that allows elective salary deferrals (such as a 401(k)) can have this feature. Auditors should be familiar with the unique attributes associated with automatic enrollment plans in order to properly design audit procedures.

Many plan sponsors have implemented automatic enrollment for their defined contribution plans as a means to increase participation and retirement savings for the employees. There are many advantages to electing an automatic enrollment plan such as:

- Helps attract and keep talented employees.
- Increases plan participation among both rank-and-file employees and owners or managers.
- Allows for salary deferrals into certain plan investments if employees do not select their own investments.
- Simplifies selection of investments appropriate for long-term retirement savings for participants.
- Helps employees begin saving for their future.
- Offers significant tax advantages (including deduction of employer contributions and deferred taxation on contributions and earnings until distribution).
- Permits distributions to employees who opt out of participation in the plan within the first 90 days.

There are several different types of automatic enrollment plans. Auditors should be familiar with these options in order to design proper audit procedures.

1. **Basic automatic enrollment (Automatic Contribution Arrangement or ACA):**
 - Employees are automatically enrolled in the plan unless they elect otherwise.
 - Plan document specifies the percentage of wages that will be automatically deducted.
 - Employees can elect not to contribute or to contribute a different percentage of pay.
2. **Eligible automatic contribution arrangement (EACA):**
 - Uniformly applies the plan's default deferral percentage to all employees after giving them the required notice.
 - May allow employees to withdraw automatic contributions, including earnings, within 90 days of the date of the first automatic contribution.
3. **Qualified automatic contribution arrangement (QACA):**
 - Uniformly applies the plan's default deferral percentage to all employees after giving them the required notice.
 - Meets *additional "safe harbor" provisions* that exempt the plan from annual actual deferral percentage and actual contribution percentage nondiscrimination testing requirements.
 - Default deferral percentage starts at 3 percent and gradually increases to 6 percent with each year that an employee participates. The default percentage cannot exceed 10 percent.

- Required employer contributions. Pick either:
 - *Matching contribution*: 100 percent match for elective deferrals that do not exceed 1 percent of compensation, plus 50 percent match for elective deferrals between 1 percent and 6 percent of compensation; or
 - *Nonelective contribution*: 3 percent of compensation for all participants, including those who choose not to make any elective deferrals.
- Employees must be 100 percent vested in the employer's matching or nonelective contributions after no more than two years of service.
- Plan may not distribute any of the required employer contributions due to an employee's financial hardship.

VI. Default investments if employee does not make an election

Employers must choose an investment for employees' automatically deducted salary deferral contributions. You can limit your liability for plan investment losses by choosing default investments for deferrals that meet certain criteria for transferability and safety, such as a life-cycle fund or balanced funds (QDIA). Your employees must be given an opportunity to change the investment choice.

It is important to note that automatic enrollment plans are subject to the same §415 and §402(g) limits established by the IRS as other types of defined contribution plans.

In accordance with the SECURE Act, for plan years beginning after December 31, 2019, the new limit is generally 15 percent except for the participant's first year, which remains 10 percent. The minimum thresholds of 3 percent to 6 percent (depending on the participation year) are unchanged. This change has a number of implications, including to enrollment procedures and participant notices; related increases in employer matching contributions; the process for changing deferral elections; plan documents; SPDs; and participant communications. Additional guidance will be needed on mid-year changes and the application of the uniformity requirement.

Furthermore, the SECURE Act provides for expanded, relaxed nonelective employer contribution safe harbor plans. Under the previous rules an annual safe harbor plan notice must be provided for a QACA or a traditional 401(k) safe harbor plan (regardless of match or nonelective employer safe harbor contribution). There is a special rule that permits a plan sponsor to adopt a safe harbor with a nonelective employer contribution by the 30th day before the close of the plan year if specific contingent and follow-up notices are provided and certain other parameters are met. However, under the new rules according to the SECURE Act, a plan sponsor can adopt a non-elective employer contribution safe harbor plan (QACA or traditional) with no participant notice requirement (unlike a safe harbor using a matching contribution). Also, this safe harbor can be adopted via a plan amendment: (1) by the 30th day before the close of the plan year; or (2) if at least a 4 percent nonelective employer contribution is made for the plan year, before the last day before distributing excess contributions for the plan year (i.e., the close of the following plan year). This new change is effective for plan years beginning after December 31, 2019. This change has a number of implications, including requiring revisions to the safe harbor policies and procedures, participant notices, plan documents, SPDs, and other participant communications; and providing flexibility for plan sponsors to address testing issues.

In accordance with the SECURE Act, the legislation creates a new tax credit of up to \$500 per year to employers to defray startup costs for new 401(k) plans and SIMPLE IRA plans that include automatic enrollment. The credit is in addition to the plan start-up credit allowed under present law and would be available for three years. The credit would also be available to employers that convert an existing plan to an automatic enrollment design.

VII. Payroll testing

In addition to determining eligibility and verifying participant data, auditors should also test payroll information. Auditors should perform procedures to test payroll data for one or more pay periods and for a number of participants. The following procedures should be considered:

- Determine that the compensation and the hours per the payroll records represent actual compensation paid and hours worked based on appropriate supporting evidence.
- Reconcile compensation from the payroll records to the plan sponsor's general ledger.
- Agree individual payrolls to the participant's earnings records.
- Test payroll rates, production tickets, or other supporting evidence.
- Test computation of hours for hourly paid employees.
- Agree rates of pay to authorization in personnel file.
- Test computation of earnings and eligible compensation as defined by the plan.

In order to comply with the audit objectives, the auditor should perform procedures related to payroll data. Confirmations can be a useful tool in testing the various forms of participant data such as birth date, hire date, pay rate, and so on. However, auditors should carefully consider the cost versus benefit of preparing confirmations, trying to get the participants to return the confirmations, and reconciling the differences, compared with other substantive procedures, which may prove to be just as effective and possibly more efficient.

Note: Multiemployer plan issues related to payroll

When auditing participant data in a multiemployer benefit plan, normally, the auditor is unable to directly test payroll records at the plan level. Plan sponsors or trustees may engage the employer's auditor, other outside auditors, in-house compliance personnel, or internal audit to perform agreed-upon procedures to test the completeness of contributions, which includes testing that all employees working for a contributing employer performing covered work (covered work is defined under the collective bargaining agreement) and any subcontracting payments for covered work have been properly reported. A representative group of contributing employers would be tested each year. The number of years the testing of contributing employers will take may vary, but a three- to four-year cycle is typical to test all employers. A plan may be so large that it may not be possible to test all of its employers. In accordance with paragraph .08 of AU-C §530, *Audit Sampling* (AICPA, *Professional Standards*), when selecting items for testing, the auditor should select items for the sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population. The auditor performing the payroll procedures typically will issue an agreed-upon procedures report in accordance with AT §201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

Multiemployer-plan procedures include the following:

- Reviewing pertinent sections of the collective bargaining agreement as a basis for considering what participant data should be tested.
- Obtaining a list of participating employers and testing its completeness by examining appropriate plan records.
- Obtaining a schedule of contributions received or receivable and agreeing the contributors to the listing of participating employers.
- Confirming directly with the participating employers the amounts remitted for the period.
- Confirming hours worked, pay rate, and any other appropriate information.
- Reviewing and testing the plan administrator's procedures as part of the normal routine, such as the plan administrator periodically visiting the employers to test data submitted to them.
- Comparing the employer's contribution reports with information shown on participant's earnings records and vice versa to determine if employees have been properly included or excluded from reports.

VIII. Contributions and contributions receivable

The area of contributions includes amounts received from both the employer and the employees. Contributions are subject to testing regardless of the scope of the engagement. Therefore, auditors should design their procedures to test the employer and employee contributions based on the auditor's understanding of the plan and its environment as well as the risk assessment.

Amounts contributed by employees are subject to restrictions established by the IRS, such as the maximum annual deferral limit and the maximum annual contribution. The plan may establish other limits on the amounts contributed by employees but only up to the maximums created by the IRS.

As stated in the 2023 AICPA *Audit and Accounting Guide for Employee Benefit Plans*, the relevant assertions for contributions and contributions receivable include the following:

- a. Amounts received or due have been appropriately determined, recorded, and disclosed in the financial statements in the proper period, in accordance with plan's provisions and in accordance with the applicable financial reporting framework.
- b. An appropriate allowance has been made for uncollectible plan contributions receivable in accordance with the applicable financial reporting framework.
- c. Participant's contributions are authorized and have been executed at the proper amount, in the proper period, and in accordance with the plan's provisions and at the participant's direction.
- d. All active participants (participants who are contributing to the plan or eligible for the employer contribution) have been properly included in the employee eligibility reports and contribution records.
- e. Appropriate and accurate participant data, including payroll information, is being utilized in determining amounts contributed to the plan.

Examples of sources of potential misstatements at the assertion level (examples of what could go wrong) related to contributions and receivables include:

- a. Employees are not appropriately included or excluded based upon the plan's provisions (for example, age or service requirements not met or part-time or leased employees).
- b. Employer or employee contributions are not properly calculated, authorized, or recorded in the proper period.
- c. Employee and employer contributions are incorrect due to the use of a definition of compensation different than what is specified in the plan's provisions, including the application of true-up contributions.

Note:

If the plan has a matching formula based on a percentage of salary deferred, then a participant may receive a true-up contribution depending on how the match is calculated. A *true-up contribution* is an additional deposit into the participant's account so that the participant receives the full, or true, match that he or she is entitled to for a given year.

- d. Contributions are not accurate, complete, or remitted in accordance with the plan's provisions (for example, manual checks, special pay, or bonuses).
- e. Participant deferral percentages entered into payroll are inaccurate, including catch-up contributions elections for participants over age 50.
- f. Profit-sharing contributions or ESOP allocations are not properly recorded.
- g. Incorrect compensation or hours are used to determine contributions.
- h. For multiemployer DC plans, participant contributions are not remitted in accordance with the collective bargaining agreement.
- i. Excess contributions such as failure to pass the actual deferral percentage test are not properly determined or recorded.

As noted previously, the auditor should identify the mistakes made in the operation and administration of the plan as well as any instances of noncompliance with the plan document and communicate accordingly with the plan sponsor. The auditor should also advise the plan sponsor of any relevant corrections that may be required depending on the nature of the error.

Employers sometimes fail to contribute the employer matching contribution according to the plan document. In many cases, the problem is caused by failing to properly count hours of service or identify plan entry dates for employees. The plan sponsor also may make incorrect contributions when you or the plan service providers fail to follow the plan document terms.

Another problem involves the timing of matching contributions. The plan's terms usually state that employer-matching contributions will be a percentage of participant deferrals, up to a specific level. Plans generally describe these matching contributions in terms of annual amounts and percentages. If your plan administrator calculates the matching contribution on a payroll period basis, rather than on an annual basis, at the end of the year, the sum of these amounts may not comply with the terms of the plan.

The auditor should recommend that the plan sponsor apply a reasonable correction method that would put affected participants in the same position they would have been in if matching contributions were made to eligible employees in accordance with plan terms. A common situation often identified by auditors is noted below along with examples of potential correction methods.

Example: Employer D sponsors a calendar-year 401(k) plan with 220 participants and plan assets that do not exceed \$1,500,000. The plan document provides that D will make matching contributions equal to 50 percent of the amount deferred by the participant for the year up to 6 percent of compensation. A participant deferring 6 percent of compensation should have a matching contribution of 3 percent of compensation.

During the 2021-plan year, D erroneously computed its match based on 50 percent of the amount deferred by Carla for the year up to 3 percent of compensation instead of 6 percent of compensation. Carla received \$50,000 in compensation and elected an 8 percent deferral rate ($\$50,000 \times 8 \text{ percent} = \$4,000$ elective deferrals). Employer D provided a matching contribution to Carla totaling \$750 ($\$50,000 \times 3 \text{ percent} \times 50 \text{ percent}$). Under the plan terms, Carla was entitled to a \$1,500 match ($\$50,000 \times 6 \text{ percent} \times 50 \text{ percent}$). As a result, Employer D needs to make a corrective contribution of \$750 plus earnings for Carla.

There are correction programs available to assist the plan sponsor when errors and mistakes have been made. To continue the example above:

Self-Correction Program – The example illustrates an operational problem because the employer did not follow the plan terms and improperly applied the plan's matching contribution formula. If the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the failure.

- No IRS imposed user fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
 - Employer D needs to make a corrective contribution by December 31, 2023.
 - If not corrected by December 31, 2023, Employer D is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program – Correction is the same as described under SCP. If the plan is not under audit, Employer D makes a (VCP) submission. Employer D's plan had assets that do not exceed \$500,000, so the *user fee* for the VCP submission made in 2018 is \$1,500. When making the submission, D must include **Forms 8950 and 8951** and consider using the model documents set forth in the Form 14568 series. The fee is higher if plan assets exceed \$500,000. VCP user fees may change in subsequent years.

Audit Closing Agreement Program – Under Audit CAP, correction is the same as under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction. The sanction under Audit CAP is based on facts and circumstances, as discussed in §14 of Rev. Proc. 2016-51.

The IRS has made important changes to the Employee Plans Compliance Resolution System (EPCRS), which allows employers that sponsor 401(k)-style defined contribution plans or defined benefit pension plans to self-correct plan operational errors.

Unless properly corrected, some errors may result not just in penalty fees but in the loss of a retirement plan's favored tax status under the Internal Revenue Code.

On July 16, 2021, the IRS issued new guidance, Rev. Proc. 2021-30, which supersedes the previous EPCRS guidance, Rev. Proc. 2019-19.

Key changes in Rev. Proc. 2021-30 include:

- **Lengthening** the time for self-correcting significant operational failures and document failures.
- **Modifying** the overpayment rules, particularly for defined benefit pension plans.
- **Increasing** the “de minimis” overpayment amount, for which no action needs to be taken, to \$250 from \$100. The plan can recoup overpayments through an installment agreement or a reduction of future benefits as opposed to just a lump sum repayment. In the case of a defined benefit plan, no recoupment of overpayments at all may be required, depending on the plan's funding level.
- **Reinstituting** the safe harbor correction methods for failure to automatically enroll participants in 401(k) features, permitting timely corrections to avoid any employer cost for the missed deferral opportunities if the problem is discovered and remediated within 9 ½ months after the end of the affected plan year.
- **Making** it easier to correct an operational error by amending the plan to match the plan's actual administrative procedures.

Most of the changes took effect as of July 16, 2021, while some will take effect January 1, 2022.

Contributions are tested to make sure that the amount withheld from an employee's pay is in accordance with the participant's wishes and that it was deposited into the appropriate participant's account.

Employer contributions are also tested in order to determine that the participant received the amount they were entitled to receive in accordance with the plan document and the allocation provisions. For efficiency purposes, the auditor may want to consider combining and coordinating the audit procedures for contributions with those for participant data testing.

In a multiemployer plan, the auditor should also obtain a list of all of the participating employers and test its completeness by examining the appropriate plan documents.

In addition to elective deferrals and employer contributions, many plans offer the participants the ability to make a Roth contribution. This feature allows employees the option to contribute to the plan on an after-tax basis but allows for tax-free growth and distribution after they have been invested for five years, and the participant has reached age 59 ½. Auditors should understand that the amounts that can be contributed under the Roth feature are subject to many more restrictions than the employee's elective deferrals.

Common deficiencies noted related to contributions and contributions receivable:

- No audit work performed or no audit documentation:
 - Due to overreliance on certification and Type 2 SOC 1 report.
- No audit program:
 - Lack of understanding of the audit objectives and procedures.
- Insufficient testing on contributing employers for multi-employer plans:
 - Failure to obtain a record of contributing employers and delinquency records.
- Failure to test employee elective deferrals:
 - Lack of understanding of audit objectives and requirements.
- Inappropriate reliance on SOC 1 report:
 - Failure to understand the differences between reducing procedures and eliminating procedures.
- Timeliness of participant contributions not tested:
 - Failure to test all of the remittances for consistency and timeliness.

IX. Participant notes receivable

Many 401(k) plans permit loans to participants. Plan sponsors should ensure that their plan document allows loans before allowing participants to borrow money from the plan. Some plan documents include a complete description of loan rules. Others make only a statement that the plan allows participant loans, subject to a separate written loan program.

A participant loan must meet several rules under IRC §72(p) to prevent the law from treating it as a taxable distribution. The rules are:

1. The loan must be a **legally enforceable agreement**:
 - It can be a paper or electronic document stating the date and amount of the loan and binding the participant to a repayment schedule.
 - It must be a secured loan, and the interest rate and repayment schedule should be similar to what a participant might expect to receive from a financial institution.
2. The **amount of the loan** cannot be more than 50 percent of the participant's vested account balance up to a maximum of \$50,000:
 - An exception allows a participant to borrow a minimum of \$10,000.
 - The loan balance is limited to (1) the greater of \$10,000 or 50 percent of the participant's vested account balance, or (2) \$50,000; whichever is less.
 - If the participant previously took out another loan, then the \$50,000 limit is reduced by the highest outstanding loan balance during the one-year period ending on the day before the new loan.

3. The **loan terms** should require the participant to make level amortized payments at least quarterly:
 - Each payment should include an allocation of principal and interest.
 - The loan must be repaid within five years unless the participant uses the loan to purchase his or her main home. The five-year repayment period is determined from date the loan was made.
4. **Exception for leave of absence:**
 - May suspend repayments for up to one year while the participant is on a leave of absence.
 - May not extend the loan's maximum repayment period.
 - On return from leave of absence, must make additional payments to ensure repayment within the five-year-period by either:
 - Increasing the payments over the rest of the loan, or
 - Keeping the payments the same but making a catch-up payment for the missed payments during the leave of absence.

Note:

A plan may suspend loan payments for more than one year for an employee performing military service. In this case, the employee must repay the loan within five years from the date of the loan, plus the period of military service.

Participant notes receivable should also have a stated reasonable interest rate. The interest rate charged for a loan cannot be more favorable than what the participant can get from a financial institution for a similarly secured loan.

As stated in the *AICPA Audit and Accounting Guide for Employee Benefit Plans*, the relevant assertions for notes receivable from participants (loans) include the following:

- All notes receivable from participants are properly recorded and exist.
- Notes receivable from participants are properly valued and disclosed in accordance with the applicable financial reporting framework.
- Notes receivable from participants are initiated in accordance with the plan's provisions.

For Form 5500 reporting purposes, participant loans are to be reported as an investment on Schedule H and included in Schedule H, Line 4i – Schedule of Assets (Held at End of Year). Because the net assets available for benefits will agree to the net assets per Form 5500, there may not be a need to include a reconciling footnote to the financial statements.

The auditor is not required to audit notes receivable from participants when a limited-scope exemption is applicable, and the notes receivable from participants have been certified by a qualifying institution.

Note:

For participant loans in which the participant has a distributable event, such as employment termination, death, or disability, the loan would be considered a distribution. The participant loan is removed from the statement of net assets available for benefits and a distribution is recorded.

For active participants who have not incurred a distributable event but have delinquent loans, the participant loan remains outstanding until a distributable event occurs.

Reporting participant loans as a note receivable from participants rather than an investment typically will not result in a difference between total net assets reported in the plan's financial statements and in the Form 5500.

The plan may continue to present loans that have been deemed distributed on an outstanding loan list as a plan asset until a distributable event, such as employment termination, death, or disability, has occurred. However, the instructions for Schedule H of the Form 5500 state that a participant loan that has been deemed distributed during the plan year should be reported as an expense if the participant loan is treated as a directed investment solely of the participant's individual account and if as of the end of the plan year, the participant is not continuing repayment under the loan. A reconciliation between participant loans reported on the Form 5500 and participant loans reported on the plan's financial statements prepared in accordance with U.S. GAAP may be necessary depending on whether for U.S. GAAP purposes the plan continues to report the delinquent loans as a note receivable from participants.

Reporting participant loans as a note receivable from participants rather than an investment typically will not result in a difference between total net assets reported in the plan's financial statements and in Form 5500.

The plan may continue to present loans that have been deemed distributed on an outstanding loan list as a plan asset until a distributable event, such as employment termination, death, or disability, has occurred. However, the instructions for Schedule H of Form 5500 state that a participant loan that has been deemed distributed during the plan year should be reported as an expense if the participant loan is treated as a directed investment solely of the participant's individual account and if as of the end of the plan year, the participant is not continuing repayment under the loan. A reconciliation between participant loans reported on Form 5500 and participant loans reported on the plan's financial statements prepared in accordance with U.S. GAAP may be necessary depending on whether for U.S. GAAP purposes the plan continues to report the delinquent loans as a note receivable from participants.

When an auditor determines that an outstanding participant note receivable does not conform to the plan or IRS provisions, then the auditor should be prepared to recommend and advise the plan sponsor about potential corrective actions.

A. Corrective action

It is important that plans have a system in place to ensure that the terms of a participant loan and its repayments follow the federal tax law, so the loan is not treated as a taxable distribution. Generally, once a loan violates a rule, the participant cannot correct it to save that exemption. The plan administrator can make corrections and preserve the exemption in a few circumstances:

- If permitted by the loan terms or written loan policy, the plan administrator may allow for a “cure period” that would allow a participant to make up for a missed payment. The cure period cannot go beyond the end of the quarter following the quarter in which the missed payment was due. However, the plan can allow a shorter cure period.
- If the participant loan violated the plan document terms or IRC §72(p), the plan sponsor has two choices. It may be able to:
 - Use the Voluntary Correction Program to permit employees to include the amount of the loan amount in income in the year of correction (as opposed to the year in which the problem occurred), or
 - Request relief from reporting the loans as taxable distributions to participants from the IRS under the VCP.
- Generally, for a plan loan to be eligible for relief from income tax reporting under VCP:
 - Employer action caused the participant’s failure to repay the loan, and
 - Correction should be done within the maximum time for the loan, usually five years from the date the original loan was made.
- The general requirements for correction are:
 - *Loan that exceeds the dollar limit:* The participant must repay the excess loan amount and, if needed, amortize the remaining principal balance as of the repayment date over the original loan’s remaining period. The corrective payment for the excess loan amount depends on the:
 - Excess amount as of the date of the loan;
 - Payments previously made on the loan; and
 - Portion of the previously made payments that were allocated to the excess loan.
 - *Loan that exceeds the maximum loan period:* The outstanding amount of the loan is reamortized over the maximum remaining period allowed under IRC §72(p). The maximum duration is determined from date the original loan was made.
 - *Loan that is in default (after the passage of the “cure period”) because of the failure to make timely payments:* The participant must either:
 - Make a lump sum payment for the missed installments (adjusted for interest);
 - Reamortize the outstanding loan balance, resulting in higher payments going forward; or
 - A combination of a make-up payment and reamortization of the loan.
- You may use the following three alternative methods to determine the allocation of prior repayments toward the excess loan amount and the corrective payment required to repay the excess loan amount:

1. Prior repayments are applied to reduce the portion of the loan that didn't exceed the limit. None of the prior payments are allocated to the excess loan amount. The corrective payment for the excess loan amount is equal to the original loan excess, plus interest.
2. Prior repayments are used to pay the interest on the excess portion of the loan, with the remainder of the repayments used to reduce the portion of the loan that didn't exceed the limit. The corrective payment for the excess loan amount is equal to the original excess loan amount.
3. Prior repayments are applied against the loan excess and the maximum loan amount permitted on a pro-rata basis. The corrective payment for the excess loan amount is equal to the outstanding loan balance attributable to the excess loan amount, after the allocation of prior repayments.

Example:

AZ Corp 401(k) Plan maintains a participant loan program. The plan has 50 participants with plan assets that exceed \$500,000 but are less than ten million dollars. AZ Corp conducted a year-end review of its loan program and found these issues:

- Bob received a plan loan on May 1, 2018. The loan was for \$60,000 over a five-year term, amortized monthly using a reasonable interest rate. Bob timely made the required payments. The loan amount is less than 50 percent of Bob's vested account balance. However, the loan amount exceeds the maximum limit of \$50,000.
- Terri received a loan of \$10,000, dated April 1, 2018, over a six-year period. Payments are timely and the interest rate is reasonable. The loan term exceeds the maximum 5-year repayment period.
- Dean borrowed \$10,000, dated March 1, 2018, over a five-year period. Because of a payroll error, AZ Corp failed to withhold the required loan repayments from Dean's pay since August 1, 201. The loan amount is less than 50 percent of Dean's vested account balance and the interest rate is reasonable.
- AZ Corp corrected the loan errors on February 1, 2019.

Corrective action

Bob: Loan amount in excess of the \$50,000 limit – AZ Corp chose to correct the mistake by allocating prior repayments using the third alternative method for loans that exceed the dollar limit (see discussion above). Since Bob has already repaid some of the loan, these repaid amounts may be considered in determining the amount of the required corrective repayment. AZ Corp applied Bob's prior repayments on a pro-rata basis between the \$10,000 loan excess and the \$50,000 maximum loan amount. Therefore, Bob's corrective repayment equaled the balance remaining on the \$10,000 loan excess as of February 1, 2019, the date of correction, after the pro-rata allocation of prior repayments.

Terri: Loan term in excess of the five-year limit – AZ Corp is correcting this mistake by reamortizing the loan balance over the maximum remaining period (five years) from the original loan date. On February 1, 2019, AZ Corp reamortized the loan balance for Terri so that it will be fully repaid by April 1, 2023 (five years from the date of the original loan).

Dean: Loan payments not made – The loan went into default as of November 2, 2018, on the expiration of the plan's stated three-month cure period. AZ Corp determined it was partially at fault because it failed to collect loan repayments. AZ Corp corrected the mistake by requiring Dean to make a lump sum repayment equal to the additional interest accrued on the loan and reamortize the outstanding balance over the remaining loan period.

Correction programs available

Self-Correction Program – This type of mistake cannot be corrected under SCP. AZ Corp must correct under VCP.

Voluntary Correction Program – If the plan is not under audit, AZ Corp makes a VCP submission per Rev. Proc. 2016-51. The user fee for the VCP submission is generally based on the amount of plan assets. In this case, the VCP user fee is \$3,000 for a submission made in 2018. VCP user fees may change in subsequent years. When AZ Corp makes its VCP submission, it must include **Forms** 8950 and 8951 and consider using the model documents in the Form 14568 series.

Audit Closing Agreement Program – Under Audit CAP, correction is the same as "Corrective Action." AZ Corp and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction. The sanction under Audit CAP is based on facts and circumstances, as discussed in §14 of Rev. Proc. 2016-51.

Self-Correction Program – Beginning April 19, 2019, some mistakes discovered or corrected on or after this date involving IRC §72(p) can be addressed using SCP if certain conditions are met. Otherwise, the VCP may be available if the plan is not under IRS examination.

Failure	Correction under SCP	Conditions
1. Loan does not meet the exceptions of IRC §72(p)(2) or is in default that is not corrected under §6.07(3). See Rev. Proc. 2021-30, sections 6.07(1) and 6.07(2).	Report deemed distribution in the year of correction instead of the year of the failure.	- Follow IRS Regs. §1.72(p) 1 in terms of reporting the deemed distribution amount on Form 1099-R. - If withholding applies under IRS Regs. §1.72(p) 1 (Q&A 15), it must be paid by the plan sponsor.
2. Defaulted loans. See Rev. Proc. 2021-30, §6.02(6) and §6.07(3)(d).	- Participant makes a single lump sum payment that includes all missed payments, including accrued interest; or - The outstanding balance of the loan, including accrued interest, is reamortized over the remaining period of the loan so that the unpaid principal and accrued interest is repaid by the end of original term of the loan or by the end of the maximum period under IRC §72(p)(2)(B), measured from the original date of the loan. - The correction methods in the first two bullets (above) can be combined. - This correction method is not available if the maximum period for repayment of the loan pursuant to IRC §72(p)(2)(B) has expired. - IRS reserves the right to limit the use of this correction method to situations that it considers appropriate.	- The participant must be willing to take actions to fix the defaulted loan. - Avoids deemed distribution. - No need to issue a Form 1099-R. - The employer should make a corrective contribution to the participant's account if the plan's rate of return exceeded the plan loan interest rate.
3. Failure to obtain spousal consent for a plan loan as required by plan terms. See Rev. Proc. 2021-30, §6.07(4).	- Notify affected participant and the participant's spouse (who was married to the participant at the time of the loan). - Obtain spousal consent to the plan loan.	- If spousal consent cannot be obtained, SCP is not available. - Correction may be available under VCP or Audit CAP.
4. Number of plan loans to a participant exceeds the number of loans permitted by written plan terms. See Rev. Proc. 2021-30, §6.07(5) and Appendix B §2.07(3).	Adopt a retroactive plan amendment to conform the written plan document to the plan's operation.	- The plan, as amended, must satisfy the IRC §72(p) requirements applicable to plan loans. - Amendment must comply with IRC §401(a) requirements. - Plan loans in excess of the number permitted by plan terms were available to all participants or solely to one or more non-highly compensated employees.

X. Distributions

Benefits paid or payable to participants and beneficiaries are determined in accordance with the plan document, which also defines the benefit amount, timing, and form of the benefits paid. The plan sponsor sets forth the requirements that assure disbursements from the plan satisfy the plan document requirements as well as other ERISA requirements.

In order to receive a distribution from a plan, a triggering event must occur. A triggering event includes:

- Termination of employment.
- Reaching age 59 ½.
- Retirement.
- Death.
- Disability.
- Qualifying hardships.

The plan document will define the eligible types of distributions and the form of payment. All defined contribution plans have distributions at some point due to terminations, retirement, and other qualifying events. Therefore, auditors should be familiar with the audit objectives in regard to distributions or benefit payments. Auditors test distributions and benefit payments to determine whether or not the participant received the amount they were entitled to receive based on plan provisions.

One of the more common issues that auditors face when it comes to distributions and benefit payments is a result of the electronic environment in which plans are operating. Many service organizations now offer participants and plan sponsors the ability to request payments via the Internet. Participants are no longer required to complete a distribution request form that is approved by the plan sponsor prior to being submitted to the service organization. Instead, the participant's log in to the service organization's secure website to request a distribution. Historically, the plan sponsor would be required to approve the distribution before the payment was made to the participant. Plan sponsors have now relinquished that approval process in exchange for the convenience of the electronic transactions. In many cases, the plan sponsor is not even notified that a distribution was processed or paid.

Caution:

Plan sponsors are still responsible for maintaining records to support the transactions that occur in the plan even when the distribution process is completely electronic between the participant and the service provider. A best practice would be for the auditor to recommend that the plan sponsor receive notifications when a distribution has either been requested or processed. The plan sponsor has a fiduciary responsibility to monitor the service providers associated with the plan.

Auditors should design their audit procedures to determine that the participant requested the distribution, was eligible to receive the distribution, and was paid the correct amount.

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

- Benefit payments have been made in accordance with plan provisions and related documents for benefit payments, hardship withdrawals, in-service withdrawals, and qualified domestic relation orders (QDROs);
- 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);
- Benefit payments are recorded in the proper account, amount, and period; and
- The payments are presented and disclosed in accordance with the applicable financial reporting framework.

The Department of Labor and the AICPA Peer Review Program have noted several deficiencies that should be addressed by auditors as well as plan sponsors. Auditors need to consider these items individually and in conjunction with each other as a means to possibly prevent future deficiencies.

- No audit documentation or no audit work performed:
 - Due to overreliance on the certification and the Type 2 SOC 1 report.
- Failure to test participant eligibility to receive benefit payments.
- Inappropriate reliance on Type 2 SOC 1 report.
- Failure to test approval of benefit payments:
 - Overreliance on services provided by third party.

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 they 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 of 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 modifies 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.

A. Hardship distributions

A 401(k) plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals. The amount of elective contributions available for a hardship distribution cannot be more than the amount of the employee's total elective contributions, including designated Roth contributions, as of the date of distribution reduced by the amount of previous distributions of elective contributions. This "maximum distributable amount" generally does not include earnings on the elective contributions, qualified nonelective contributions or qualified matching contributions. Qualified nonelective contributions (QNECs) and/or qualified matching contributions are typically made to correct failed Actual Deferral Percentage (ADP) or Actual Contribution Percentage (ACP) tests. Other amounts under the plan, if any, such as regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides.

The employee cannot roll over hardship distributions to another plan or IRA. The law treats a distribution as a hardship distribution only if it is made both because of an employee's immediate and heavy financial need and is limited to the amount necessary to satisfy that financial need. The employer determines whether an employee has an immediate and heavy financial need based on all relevant facts and circumstances; however, under the safe harbor standard, the law deems a distribution to be made because of an employee's **immediate and heavy financial need** if the distribution is for:

- Medical care expenses previously incurred by the employee, the employee's spouse, or any dependents of the employee, or if necessary, for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, the employee's spouse, children, or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or mortgage foreclosure on that residence;
- Funeral expenses for the employee's deceased parent, spouse, etc.;
- Certain expenses relating to the repair of damage to the employee's principal residence; or
- Expenses and losses incurred by the employee on account of a disaster declared by FEMA, provided the employee's principal residence or principal place of employment at the time of declaration was in the declaration area.

In addition to demonstrating immediate and heavy financial need, the plan must also demonstrate that a **distribution from the plan is necessary to address the need**. A distribution is not considered necessary to satisfy an immediate and heavy financial need of an employee if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children.

Whether other resources are available is determined based on facts and circumstances.

For example, the plan sponsor may determine that the facts and circumstances for determining whether distributions from the plan are necessary to address the immediate and heavy financial need, if the employee provides the plan sponsor with written representation that the need cannot be adequately addressed from other sources such as:

- Through reimbursement or compensation by insurance or otherwise;
- By liquidating the employee's assets;
- By ceasing elective deferrals or employee contributions under the plan; or
- By other distributions or nontaxable loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

The plan sponsor may be able to rely on such representations unless you have knowledge that informs the plan sponsor that the representations are not correct.

A need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, a plan loan cannot reasonably relieve the need for funds to

purchase a principal residence if the loan would disqualify the employee from obtaining other necessary financing.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if:

1. The employee has obtained all other currently available distributions and loans under the plan and all other plans maintained by the employer; and
2. The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution.

A hardship distribution may not exceed the amount of the employee's need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution.

It is important that the plan sponsor keep a record of all information used to determine whether a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship. The IRS has provided some guidelines for substantiation of Safe-Harbor Hardship Distributions from 401(k) plans.

Hardship distributions may be subject to the 10 percent early distribution tax on distributions made prior to reaching age 59 ½.

Auditors should include hardship distributions in the scope of total distributions from the plan in order to determine that the payments were in accordance with plan provisions.

1. *Bipartisan Budget Act*

On September 23, 2020, the IRS published final regulations amending the rules governing hardship distributions from 401(k) and 403(6) plans pursuant to changes contained in the Bipartisan Budget Act of 2018 (Act).

The IRS's final regulations make the following key changes: (1) requiring plans to eliminate the six-month suspension of contributions following a hardship distribution made on or after January 1, 2020; (2) permitting plans to eliminate the requirement that participants obtain all available plan loans prior to receiving a hardship distribution; (3) expanding the types of contribution sources available for hardship distributions; (4) adding a new type of safe harbor hardship expense for losses relating to a federally-declared disaster; and (5) updating the administrative process required to document that the distribution is necessary to meet the financial need.

For hardship distributions made on or after January 1, 2020, no suspension of employee contributions is permitted in connection with a hardship withdrawal from any qualified plan, 403(b) plan, or governmental 457(b) plan.

For hardship distributions made on or after January 1, 2020, the historic catch-all “relevant facts and circumstances” test is eliminated in determining whether a distribution is necessary to satisfy a financial need and replaced with a single, general, more objective standard. The determination under the new standard for 401(k) and 403(b) plans requires that:

- A hardship distribution does not exceed the amount of the employee’s need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution);
- The employee first obtains other available distributions (this includes all currently available distributions, such as available ESOP dividends, but not hardship distributions or loans under the plan and all other plans of deferred compensation maintained by the employer whether qualified or nonqualified); and
- The employee represents (in writing or by an electronic medium, including, for example an online application or verbally during a telephone conversation that is recorded, or other forms prescribed by the IRS) that he or she has insufficient cash or liquid assets “reasonably available” to satisfy the financial need.

A Plan administrator may rely on an employee’s representation unless the plan administrator has actual knowledge to the contrary.

Plan amendments will be needed to reflect the hardship changes.

B. Vesting

The plan document will specify the applicable vesting provisions. The deferral amounts contributed to the plan are not subject to the vesting provisions because a participant is always 100 percent vested in their own contributions. Amounts contributed by the employer are subject to the vesting provisions and plans are required to vest in a manner that equals or exceeds either of the two alternative schedules:

1. Graded vesting where the employee is at least 20 percent vested after two years of service and 20 percent per year each year thereafter for the next three years; the employee would be 100 percent vested after six years.
2. The employee would be 100 percent vested after three years of service.

The employer must maintain sufficient records to support the employee’s period of employment in order to determine their eligibility to receive benefits.

Due to the fact that participants are requesting distributions via the Internet, the plan sponsor may not be required to review or approve of the payment or the amount. This type of situation should heighten the auditor’s risk assessment due to the potential for errors and mistakes. Plan sponsors must be diligent in their efforts to provide accurate information to the service organization.

A common mistake made by plan sponsors is failure to follow the terms of the plan document. If an error in the operation of your plan is identified, then a correction should be made as soon as possible. The plan sponsor should use a reasonable correction method that places affected participants in the same position they would have been in had the mistake not occurred. Rev. Proc. 2016-51 §6 provides general correction principles that the plan sponsor should use in determining an appropriate correction method.

Example:

Employer A's 401(k) plan provides for employer matching contributions of 50 percent of the deferrals made to the plan, up to the first 6 percent of compensation. The plan provides that these employer-matching contributions vest at the rate of 20 percent per year. Net plan assets reported on the most recently filed Form 5500 are less than \$500,000. A participant must work at least 1,000 hours in a calendar year to receive vesting credit for that year. Bob participated in the plan from January 1, 2011, to September 30, 2014, when he terminated employment. Bob worked 2,000 hours in 2011, 2012, and 2013, and during 2014, the year of termination, Bob worked 1,100 hours. At termination, Employer A paid Bob his plan benefits in a lump sum. At that time, Bob's employer matching contribution account balance was \$5,000. Employer A calculated Bob's vested percentage as 60 percent, 20 percent for each of the three full calendar years he was employed. Bob was paid \$3,000 from his employer matching contribution account.

A mistake has occurred because Employer A should've credited Bob with a vesting year of service for 2014 since he worked in excess of 1,000 hours in that plan year. Bob should have been 80 percent vested for the four years of vesting service.

Reasonable correction – Employer A must make a corrective distribution to Bob to correct the vesting mistake. Employer A should credit Bob with an additional 20 percent of the account balance of \$5,000, or \$1,000, plus any additional earnings from the date of the original distribution to the date of the corrective distribution.

Correction programs available

Self-Correction Program – The example illustrates an operational problem because Employer A did not follow the plan terms by improperly vesting Bob's account. If the other eligibility requirements of SCP are satisfied, Employer A may use SCP to correct the mistake.

- No IRS imposed fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
 - Employer A needs to make corrective contribution to the plan and have the Plan make a distribution to Bob by December 31, 2016.
 - If not corrected by December 31, 2016, Employer A is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer A can take corrective actions to fix the mistake beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program – Correction is the same as described above under SCP. If the plan is not under audit, Employer A makes a VCP submission according to Re. Proc. 2016-51. The 2018 *user fee* for most VCP submissions is \$1,500 given the amount of net plan assets. If the amount of net plan assets exceeds \$500,000, the user fee is higher. VCP user fees may change in subsequent years. When making the VCP submission, A must include **Forms 8950 and 8951** and consider using the *model documents* set forth in the Form 14568 series.

Audit Closing Agreement Program – Under Audit CAP, correction is the same as described above under SCP. Employer A and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction. The sanction under Audit CAP is based on facts and circumstances, as discussed in §14 of **Rev. Proc. 2016-51**.

C. Forfeitures

When a participant terminates employment and they are less than 100 percent vested, the unvested portion of their account balance is forfeited. The plan document will define how forfeitures are to be treated.

As stated in the *AICPA Audit and Accounting Guide for Employee Benefit Plans*, the relevant assertions for forfeitures include the following:

- Forfeiture amounts are properly recorded and exist.
- Forfeiture accounts are properly presented and disclosed in the financial statements (for example, when forfeitures are used to offset future employer contributions, they are shown as a reduction of employer contribution receivable).
- Forfeiture amounts are used only in accordance with the plan document (for example, pay plan expenses, reallocated to current participants, or used to reduce future employer contributions).

Auditors should test the forfeitures to make sure that they are used in accordance with the plan provisions. When the forfeitures are reallocated to remaining employees, the auditor should test that the amount that was reallocated was in accordance with the allocation provisions in the plan document.

In regard to the forfeiture account, the auditor often overlooks the activity in the account as long as the balance at the end of the year decreases. Unfortunately, this oversight leaves the auditor vulnerable to risks associated with the financial statements. There are many things that may flow through the forfeiture account including employer contributions, plan fees, reallocations, and so on, therefore the auditor should be able to identify the activity in order to properly test the forfeitures. If forfeitures are to be reallocated back to remaining plan participants, then the auditor should test the amount allocated to make sure the allocation is in accordance with the plan document.

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Financial Statements and Audit Reporting

Learning objectives

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

- Identify common audit report deficiencies;
- Understand the required financial statement format and presentation; and
- Identify the required disclosures unique to 401(k) plans.

I. Audit report deficiencies

The DOL and peer reviewers identified the following issues as common audit deficiencies:

- The auditor's report was not properly dated. This was usually because the report was reissued as a result of additional disclosures or audit procedures, and the report was not dual dated or re-dated. However, we have also seen instances where the report was dated before sufficient evidence was obtained.
- The first paragraph of the report did not identify the financial statements and/or supplementary schedules being reported upon.
- The auditor failed to opine on all statements included in the financial statements or on supplementary information attached to the financial statements.
- The auditor did not opine on one or more of the prior year financial statements presented.

II. Recently issued standards

A. SAS No. 136

Statement on Auditing Standards (SAS) No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, is effective for audits of financial statements for periods ending on or after December 15, 2021. 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:

- AU-C §700, *Forming an Opinion and Reporting on Financial Statements*; and
- Paragraph .09 of AU-C §725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

This SAS also addresses the auditor's responsibilities for forming an opinion and reporting on ERISA plan financial statements, including the form and content of the report when management elects to have an audit performed pursuant to ERISA §103(a)(3)(C) (hereinafter referred to as an ERISA §103(a)(3)(C) audit).

In accordance with SAS No. 136, there will no longer be any references to limited-scope audits. Instead, management may engage an auditor to perform an **ERISA §103(a)(3)(C) audit**. This is 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. 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 statement

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.
- 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 §103(a)(3)(C).

2. Supplemental schedules

When management elects to have an ERISA §103(a)(3)(C) audit, the auditor should include an Other Matter paragraph in the ERISA §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 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.
- 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 §103(a)(3)(C).

3. Procedures

Following are the procedures for an ERISA §103(a)(3)(C) audit:

- a. When management elects to have an ERISA §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.
- b. 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 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 his or her concerns with those charged with governance and determine the implications for the audit.
- c. The auditor should identify which investment information is certified.
- d. The auditor should perform the following procedures on the certified investment information:
 - Obtain from management and read the certification as it relates to investment information prepared and certified by a qualified institution;
 - Compare the certified investment information with the related information presented and disclosed in the ERISA plan financial statements and ERISA-required supplemental schedules; and
 - 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.

III. Example audit reports

The standard audit reports engagements are fairly straight forward. However, when there is a special circumstance such as an initial audit when prior year was audited by predecessor auditor, an initial audit for existing plan that has never been audited, a change in trustee/custodian or certification only covers a portion of the total investments, the auditor needs to modify the standard audit report accordingly. The following examples provide guidance on the modifications that may be necessary depending on the circumstances.

Discussion question:

In the event of an initial audit, do you compile the prior year? Audit the prior year? If the prior year is compiled, do you issue a separate report or include it in the current year audit report?

A. Auditor's report for a defined contribution retirement plan subject to ERISA

Circumstances:

- The auditor performed a non-§103(a)(3)(C) audit as of and for the years ended December 31, 2022, and 2021, in accordance with GAAS. The auditor implemented SAS Nos. 134-140 for the December 31, 2021, plan year.
- The auditor has concluded that an unmodified (clean) opinion on the ERISA plan financial statements is appropriate based on the audit evidence obtained.
- In accordance with paragraph .86 of AU-C §703, when the auditor is 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. 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-§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.
- The report on the 2021 ERISA-required supplemental schedules is presented in a separate section in accordance with paragraphs .129-.130 of AU-C §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 Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

Paragraph .86 of AU-C §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 §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] <u>Opinion</u> 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, 2022 and 2021, and the related statement of changes in net assets available for benefits for the year ended December 31, 2022, 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, 2022 and 2021, and the changes in its net assets available for benefits for the year ended December 31, 2022, in accordance with accounting principles generally accepted in the United States of America. <u>Basis for Opinion</u> 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. <u>Responsibilities of Management for the Financial Statements</u> 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 <i>[insert the time period set by the applicable financial reporting framework]</i>. 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.

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

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:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- 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.
- 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.
- 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.
- 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]

B. Modifications to the opinion

AU-C §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 §103(a)(3)(C) audit, the auditor should apply the requirements in AU-C §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; 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 §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 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 §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.

C. ERISA §103(a)(3)(C) audit report in the year of implementation

Circumstances:

- Management elected an ERISA §103(a)(3)(C) audit for the 2022 and 2021 plan year financial statements as permitted by Code of Federal Regulations (CFR), Labor, Title 29, §2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.
- The auditor performed an ERISA §103(a)(3)(C) audit as of and for the years ended December 31, 2025, and 2024, in accordance with GAAS. The auditor implemented SAS Nos. 134-140 for the December 31, 2024, plan year.
- The auditor has concluded that the ERISA §103(a)(3)(C) report is appropriate as of and for the year ended December 31, 2024, based on the audit evidence obtained.
- The report on the 2024 ERISA-required supplemental schedules is presented as an Other Matter paragraph in accordance with paragraph .132 of AU-C §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 §103(a)(3)(C).

Independent Auditor's Report²

[Appropriate addressee]

Scope and Nature of the ERISA §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 §103(a)(3)(C) (ERISA §103(a)(3)(C) audit). The financial statements comprise the statements of net assets available for benefits as of December 31, 2025, and 2024, 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 §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 §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, 2022, and 2021, 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:

- 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.
- 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 §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 §103(a)(3)(C) audit opinion.

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 §103(a)(3)(C) audit does not affect management's responsibility for the financial statements.

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

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 §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:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- 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.
- 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.
- 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.
- 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.

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 §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:

- 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.
- 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 §103(a)(3)(C).

[Signature of the auditor's firm]

[City and state where the auditor's report is issued]

[Date of the auditor's report]

D. Modifications to the ERISA §103(a)(3)(C) report

AU-C §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 §103(a)(3)(C) audit, the auditor should apply the requirements in AU-C §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 §103(a)(3)(C).

- b. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the phrase “except for the possible effects of the matter(s)…” for the modified opinion.
- c. 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.
- d. 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 §103(a)(3)(C) audit opinion.
- e. When the auditor disclaims an opinion, the auditor should amend the statement required by paragraph 103*b*, 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.”
- f. 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.

E. Prior period financial statements

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.

IV. Financial statement example

A comprehensive example of a 401(k) plan is presented below to emphasize the required format of the financial statements and related disclosures.

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.

ABC 401(k) Profit-Sharing Plan Statements of Net Assets Available for Benefits December 31, 20X5 and 20X4		
	20X5	20X4
ASSETS		
Investments at fair value	\$ 16,608,081	\$ 14,486,784
Receivables:		
Participant contributions receivable	28,721	29,146
Employer contribution receivable	—	6,222
Participant notes receivable	170,261	160,165
Total receivables	198,982	195,533
Total assets	16,807,063	14,682,317
LIABILITIES		
Refunds of excess contributions	25,610	—
NET ASSETS AVAILABLE FOR BENEFITS	\$ 16,781,453	\$ 14,682,317
See accompanying notes to financial statements.		3

ABC 401(k) Profit-Sharing Plan Statements of Changes in Net Assets Available for Benefits for the Years Ended December 31, 20X5 and 20X4		
	20X5	20X4
ADDITIONS		
Investment income:		
Net appreciation (depreciation) in fair value of investments	\$ 992,386	\$ (915,174)
Interest	9,497	7,822
Dividends	357,848	944,130
	<u>1,359,731</u>	<u>36,778</u>
Contributions:		
Participants	995,702	907,498
Employer	172,552	174,327
Rollover	31,124	52,619
Total contributions	<u>1,199,378</u>	<u>1,134,444</u>
Total additions	<u>2,559,109</u>	<u>1,171,222</u>
DEDUCTIONS		
Benefits paid to participants	363,197	530,783
Corrective distributions	41,140	18,774
Deemed distributions	—	9,520
Fees and commissions	55,636	56,148
Total deductions	<u>459,973</u>	<u>615,225</u>
INCREASE IN NET ASSETS AVAILABLE FOR BENEFITS	2,099,136	555,997
NET ASSETS AVAILABLE FOR BENEFITS		
Beginning of year	14,682,317	14,126,320
End of year	<u>\$16,781,453</u>	<u>\$14,682,317</u>
See accompanying notes to financial statements.		4

ABC 401(k) Profit-Sharing Plan
Notes to the Financial Statements
for the Years Ended December 31, 20X5 and 20X3

Contributions – Upon meeting the eligibility requirements, participants may contribute on a pre-tax basis. Participants may voluntarily change their deferral amounts on a quarterly basis or elect to decline participation. The maximum deferral percentage is 100 percent of their eligible compensation, as defined by the Plan, not to exceed \$23,500 and \$23,000 in 20X5 and 20X4, respectively, subject to certain discrimination tests prescribed by the Internal Revenue Code. Participants who have attained age 50 before the end of the Plan year are eligible to make catch-up contributions. The Company makes a matching contribution equal to 25 percent of the amount deferred up to 10 percent. The Company may make discretionary non-elective contributions to the Plan which will be allocated to each participant's account based on their individual compensation as a percentage of total compensation, although the Company is not required to do so. During the years ended December 31, 20X5 and 20X4, the Company did not make any non-elective contributions. Contributions are subject to certain IRS limitations.

Participants may also contribute certain rollover amounts representing distributions from other qualified defined benefit or defined contribution plans.

Participant Accounts – Each participant's account is credited with the participant's contributions, allocations of the Company's contribution, Plan earnings, and charged with an allocation of investment gains or losses, withdrawals, and administrative expenses. Allocations are based on participant earnings, account balances, or specific participant transactions, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

Investments – Upon enrollment in the Plan, participants direct the investment of their contributions and Company contributions into various investment options offered by the Plan.

Vesting – Participants are vested immediately in their contributions plus actual earnings thereon. Vesting in the Company's contribution portion of their accounts is based on years of continuous service. Employees vest 20 percent per year after completing two years of service until becoming 100 percent vested after six years of credited service in accordance with the Plan document, or immediately if employment is terminated due to death, disability, or retirement upon attainment of the age of 65.

Notes Receivable from Participants – The Plan permits participants to borrow a minimum of \$1,000 up to 50 percent of their vested account balance not to exceed \$50,000. The notes are secured by the balance in the participant's account and bear interest at 4.25 percent-4.75 percent which is commiserate with local prevailing rates. Principal and interest are paid ratably through payroll deductions and notes must be fully repaid within five years. Participant notes receivable are valued at their outstanding principal balance plus accrued and unpaid interest. As of December 31, 20X5 and 20X4, the Plan had outstanding notes to participants with principal balances totaling \$170,261 and \$160,165, respectively.

Payment of Benefits – On termination of service due to death, disability, or retirement, a participant could elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or various forms of annuities, as provided in the Plan document. For termination of service for other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

Forfeitures – At December 31, 20X5 and 20X4, forfeited non-vested accounts totaled \$22,162 and \$8,639, respectively. These accounts will be used to reduce future employer contributions to the Plan. Also, employer contributions were reduced by \$40,110 and \$18,738 for the years ended December 31, 20X5 and 20X4.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting – The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America, except that benefits paid to Plan participants are recorded on a cash basis.

Use of Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and changes therein, disclosure of contingent assets and liabilities. 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. Plan management determines the Plan's valuation policies utilizing information provided by the investment advisers and trustee. See Note X for discussion of fair value measurements.

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

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 an 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 and 20X4.

Contributions – Contributions from employees are recorded as they are withheld from the participant's wages.

Excess Contributions Refundable – 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 20X5 excess contributions to the applicable participants prior to March 15, 20X6.

Payment of Benefits – Benefit payments to participants are recorded when paid.

Administrative Expenses – Administrative expenses of the Plan are paid by the Plan, as provided in the Plan document. Expenses that are paid by the Company are excluded from these financial statements. Fees related to the administration of the notes receivable from participants are charged directly to the participant's account. Investment-related expenses are included in net appreciation (depreciation) of fair value of investments.

3. INVESTMENTS (UNAUDITED)

The Plan's investments were held in trust and administered by the trustees, XYZ Banking and Trust Company for the years ended December 31, 20X5 and 20X4. All investment information disclosed in the accompanying financial statements and supplemental schedule was obtained or derived from information supplied to the Plan administrator and certified as complete and accurate by the trustee.

4. FAIR VALUE MEASUREMENTS

Fair value measurements in accordance with current accounting standards, establishes a framework for measuring fair value. That framework 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 measurements) and the lowest priority to unobservable inputs (level 3 measurements).

The three levels of the fair value hierarchy 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:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- 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 used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value at December 31, 20X5 and 20X4:

- 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.
- Stable value: The Plan invests in a stable value collective trust valued at the NAV of the units of a bank collective trust. The NAV, as provided by the trustee, is used as a readily determinable fair value to estimate fair value. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. This readily determinable fair value 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 (purchases and sales) may occur daily. Were the Plan to initiate a full redemption of the collective trust, the investment advisor 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.

The following tables set forth by level, within the fair value hierarchy, the Plan's investment assets at fair value as of December 31, 20X5 and 20X4.

Assets at Fair Value as of December 31, 20X5				
	Level 1	Level 2	Level 3	Total
Stable value	\$ —	\$ 1,129,182	\$ —	\$ 1,129,182
Mutual funds	<u>15,478,899</u>	<u>—</u>	<u>—</u>	<u>15,478,899</u>
Total at fair value	<u>\$ 15,478,899</u>	<u>\$ 1,129,182</u>	<u>\$ —</u>	<u>\$ 16,60,081</u>

Assets at Fair Value as of December 31, 20X4				
	Level 1	Level 2	Level 3	Total
Stable value	\$ —	\$ 1,067,360	\$ —	\$ 1,067,360
Mutual funds	<u>13,419,424</u>	<u>—</u>	<u>—</u>	<u>13,419,424</u>
Total at fair value	<u>\$ 13,419,424</u>	<u>\$ 1,067,360</u>	<u>\$ —</u>	<u>\$ 14,486,784</u>

5. RELATED-PARTY TRANSACTIONS AND PARTY-IN-INTEREST TRANSACTIONS

Certain Plan investments are managed by Branch Banking and Trust Company, the trustee of the Plan and therefore, these transactions qualify as party-in-interest transactions. Fees paid by the Plan for investment management services were included as a reduction of the return earned on each fund. Certain administrative fees related to the administration of the Plan were paid by the Plan or by the Company. These transactions qualify as party-in-interest transactions.

6. PLAN TERMINATION

Although it has not expressed any intention 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 set forth in ERISA. In the event that the Plan is terminated, participants would become 100 percent vested in their accounts.

7. FEDERAL INCOME TAX STATUS

The Company has adopted a prototype standardized plan pre-approved by the Internal Revenue Service (IRS). The IRS issued an opinion letter dated March 31, 2024, that the prototype standardized plan is acceptable with the applicable section of the Internal Revenue Code. Although the Plan has been amended since receiving the opinion letter, the Company and the Plan administrator believe that the Plan is currently designed and operated in compliance with the applicable requirements of the IRC and the Plan and related trust continue to be tax-exempt. Therefore, no provision for income taxes 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.

8. RISKS AND UNCERTAINTIES

The Plan invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect participants' account balances and the amounts reported in the Statements of Net Assets Available for Benefits.

9. DELINQUENT PARTICIPANT CONTRIBUTIONS

For the year ended December 31, 20X5, there was \$1,482 of participant contributions related to the 20X4 plan year that were not remitted to the Plan until 20X5. This amount has been reported on the Supplemental Schedule of Delinquent Participant Contributions accordingly.

10. SUBSEQUENT EVENTS

For the year ended December 31, 20X5, the Company evaluated subsequent events for potential recognition and disclosure through September 20, 20X6, the date of financial statement issuance. As a result of the spread of COVID-19, economic uncertainties have arisen which are likely to negatively impact investment income and other Plan transactions. Other financial impact could occur though such potential impact is unknown at this time.

ABC 401(k) Profit-Sharing Plan				
Schedule H, line 4a – Schedule of Delinquent Participant Contributions				
December 31, 20X5			EIN: 13-XXXXXXX Plan number: 001	
Participant Contributions Transferred Late to Plan	Total That Constitutes Non-Exempt Prohibited Transactions Contributions Not Corrected	Contributions Corrected Outside of VFCP	Contributions Pending Correction in VFCP	Total Fully Corrected Under VFCP and PTE 2002-51
\$1,482		\$1,482		

V. Financial statement 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:

- General description of the plan;
- Summary of significant accounting policies;
- Plan's tax status;
- Plan termination;
- Master trust information if the plan participates in a master trust;
- Risks and uncertainties;
- Plan mergers and terminations;
- Party-in-interest transactions;
- Subsequent events;
- Limited-scope information;
- Plan amendments adopted during the year;
- Form 5500 reconciliations, as necessary; and
- 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 usually includes 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.

The following pages provide some additional examples of disclosures.

A. Fair value measurements

The following pages provide examples of fair value measurement footnotes.

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 is able to access. |
| Level 2 | <p>Inputs to the valuation methodology include:</p> <ul style="list-style-type: none">• Quoted prices for similar assets or liabilities in active markets;• Quoted prices for identical or similar assets or liabilities in inactive markets;• Inputs other than quoted prices that are observable for the asset or liability; and• Inputs that are derived principally from or corroborated by observable market data by correlation or other means. <p>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.</p> |
| 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.

The 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, 20X2 and 20X1.

- Common stocks: Valued at the closing price reported on the active market in which the individual securities are traded.
- 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.
- 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.
- 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.
- 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 (NAV) 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 NAV	—	—	—	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 NAV	—	—	—	1,322,000
Total investments	\$4,322,500	\$332,500	\$20,000	\$5,997,000

Transfers Between Levels

For the years ended 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

For the years ended December 31, 2025, and 2024, the Plan's level 3 assets included purchases of \$456,999 and \$227,886; sales of \$615,550 and \$286,678; and transfers of \$(57,413) and \$(32,538), respectively.

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	\$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 No. 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.

The following is an 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

Depending on the circumstances, the following additional disclosures to the financial statements may be required.

B. Risks and uncertainties

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.

C. 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 issued. There are two types of subsequent events:

- 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).
- 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, non-recognized subsequent events).

Recognized and non-recognized 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:

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

Note X: Subsequent Events

On February 16, 20X4, 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, 20X4, 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, 20X4, 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, 20X4. 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, 20X4, 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, 20X4, into the Plan. On March 19, 20X4, \$2,828,654 was transferred to the Plan.

On April 16, 20X4, 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, 20X4.

D. Investment contracts

The following is an example of the disclosure for an investment contract with an insurance company.

Note X: 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	<u>250,000</u>	<u>150,000</u>
Total	<u>\$ 1,500,000</u>	<u>\$ 650,000</u>

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:

1. The Plan's failure to qualify under §401(a) of the Internal Revenue Code or the failure of the trust to be tax-exempt under §501(a) of the Internal Revenue Code.
2. Premature termination of the contracts.
3. Plan termination or merger.
4. Changes to the Plan's prohibition on competing investment options.
5. 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:

1. An uncured violation of the Plan's investment guidelines.
2. A breach of material obligation under the contract.
3. A material misrepresentation.
4. A material amendment to the agreements without the consent of the issuer.

E. Reconciliation to Form 5500

The following is an example of a reconciliation of net assets to Form 5500.

Note X: Reconciliation of Financial Statements to Form 5500

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

	20X5	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	<u>(12,350)</u>	<u>(11,475)</u>
Net assets available for benefits per the Form 5500	<u>\$ 43,187,622</u>	<u>\$ 40,258,556</u>

The following is a reconciliation of the change in net assets available for benefits per the financial statements to the Form 5500 for the years ended December 31, 20X5 and 20X4.

	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	28,716	—
Rounding	<u>2</u>	<u>—</u>
Change in net assets available for benefits per the Form 5500	<u>\$ 3,028,802</u>	<u>\$ 3,828,727</u>

Other following disclosures may be required as applicable.

F. Benefit claims

The following is an example of a benefit claims payable footnote.

Note X: 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 Form 5500 includes benefit claims payable because a reconciling footnote may be necessary if a liability is recorded on Form 5500 and not the financial statements.

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.

G. 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.

The following is an example of plan termination footnote.

Note X: Plan Mergers and Terminations

On April 28, 20X5, 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, 20X5.

H. Concentrations

The following is an example of a concentration footnote.

Note X: Concentrations

As of December 31, 20X5 and 20X4, 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.

I. Commitments and contingencies

The following is an example of a commitments and contingencies footnote.

Note X: Commitments and Contingencies

From 1997 to January 20X5, 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, 20X5, 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

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Additional Considerations

Learning objectives

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

- Analyze audit requirements relating to subsequent events;
- Identify other unique considerations for 401(k) plans;
- Identify auditor responsibilities for the financial information on Form 5500;
- Recall audit considerations associated with initial audits and plan terminations (partial and full);
- Identify the tax related considerations for 401(k) plans; and
- Recall appropriate audit wrap-up and completion procedures.

I. Introduction

In this chapter we will wrap up some loose ends in regard to auditing employee benefit plans. The items discussed here may seem basic to the experienced auditor, but it is sometimes the simple things that create problems for auditors. Therefore, auditors need to be as thorough with their audit procedures nearing the completion of the audit as they are in the beginning stages.

II. Form 5500

Form 5500 was jointly developed by the DOL, IRS, and the Pension Benefit Guaranty Corporation so that pension plans could utilize the Form 5500 series to comply with the annual reporting requirements under Title 1 and Title IV of ERISA as well as the internal revenue code.

A part of ERISA's overall reporting and disclosure framework includes the Form 5500 Series. The Form 5500 series was created to assure that employee benefit plans are operated and managed in accordance with certain prescribed standards and that participants and beneficiaries, as well as regulators, are provided or have access to sufficient information to protect the rights and benefits of participants and beneficiaries under employee benefit plans.

The DOL utilizes the Form 5500 series as a compliance, research, and disclosure tool, as well as a disclosure document for plan participants and beneficiaries. The series also serves as a source of information and data for use by other federal agencies, Congress, and the private sector in assessing employee benefit, tax, and economic trends and policies.

Form 5500 is an informational return that is utilized by the DOL and other federal agencies and is a required part of the reporting requirements under ERISA. Therefore, it is imperative that auditors understand the filing requirements and penalties that the plan administrator is subject to for failure to comply.

In accordance with the original SECURE Act, legislation modifies the failure-to-file penalties for retirement plan returns. The Form 5500 penalty would be modified to \$105 per day, not to exceed \$50,000. Failure to file a registration statement would incur a penalty of \$2 per participant per day, not to exceed \$10,000. Failure to file a required notification of change would result in a penalty of \$2 per day, not to exceed \$5,000 for any failure. Failure to provide a required withholding notice results in a penalty of \$100 for each failure, not to exceed \$50,000 for all failures during any calendar year. Increasing the penalties will

encourage the filing of timely and accurate information returns and statements and the provision of required notices, which, in turn, will improve overall tax administration.

The auditor is required to reconcile the financial information on Form 5500 to the audited financial statements. However, as mentioned previously, many plan sponsors rely on the auditor to review and correct Form 5500 on their behalf. Auditors should explain the requirements to the plan sponsor and if necessary, revise the engagement letter for additional services if the auditor is to review the entire Form 5500. Therefore, auditors should understand the different schedules that may be required depending on the nature of the plan.

A. Schedule A

If there are any benefits provided by an insurance company, insurance service, or other similar organization, then the Schedule A must be attached to the Form 5500 filing. Insurance products include but are not limited to insurance contracts, pooled separate accounts, and guaranteed investment contracts.

B. Schedule C

Schedule C is required for a large plan, Master Trust Investment Account (MTIA), 103-12 Investment Entity or Guaranteed Investment Account (GIA) if:

1. Part I must be completed for any service organization who rendered services to the plan or Direct Filing Entity (DFE) during the plan or DFE year that received \$5,000 or more in compensation, directly or indirectly from the plan or DFE.
2. Part II must be completed if service organizations fail to provide information necessary to complete Part I of the Schedule C.
3. Part III must be completed if an accountant or enrolled actuary has been terminated.

C. Schedule D (Direct Filing Entity)

A Direct Filing Entity (DFE) is defined as a plan that participates in certain trusts, accounts, and other investment arrangements that file the Form 5500 annual return/report as a DFE in accordance with the Direct Filing Entity Filing Requirements. A Form 5500 must be filed for a master trust investment account (MTIA). A Form 5500 is not required but may be filed for a common/collective trust (CCT), pooled separate account (PSA), 103-12 investment entity (103-12 IE), or group insurance arrangement (GIA).

Plans that participate in CCTs, PSAs, 103-12 IEs, or GIAs that file as DFEs, however, generally are eligible for certain annual reporting relief. For reporting purposes, a CCT, PSA, 103-12 IE, or GIA is not considered a DFE unless a Form 5500 and all required attachments are filed for it in accordance with the Direct Filing Entity (DFE) Filing Requirements.

Part I is required for a plan or DFE that invested or participated in any MTIAs, 103-12 IEs, CCTs, or PSAs.

Part II is required when the Form 5500 is filed for a DFE.

D. Schedule G

A Schedule G is required for a large plan, MTIA, 103-12 IE, or GIA when Schedule H (Financial Information) Lines 4b, 4c, or 4d are checked "Yes."

Part I of the Schedule G reports loans or fixed income obligations in default or classified as uncollectible.

Part II of the Schedule G reports leases in default or classified as uncollectible.

Part III of the Schedule G reports nonexempt transactions.

Note:

Untimely remittances are no longer reported on Schedule G, schedule of nonexempt transactions; instead, untimely remittances are reported on the Schedule of Delinquent Contributions.

E. Schedule H

Large plans and DFE's report financial information on Schedule H. If the schedule H is filed, then plans are generally required to attach the opinion of a qualified independent public accountant. Furthermore, large plans generally require a Schedule of Assets (Held at End of Year) and other supplemental schedules as applicable (see below).

F. Other schedules

The following schedules are applicable for defined benefit pension plans:

- Schedule R – Plans subject to code Section 412.
- Schedule MB – Actuarial information for multiemployer defined benefit plans.
- Schedule SB – Actuarial information for single employer defined benefit plans.

By understanding the various schedules that may be included with an annual Form 5500, auditors are better able to review and reconcile the financial information to the audited financial statements.

G. 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:

- Schedule G, Part I – Schedule of loans or fixed income obligations in default.
- Schedule G, Part II – Schedule of leases in default.
- Schedule G, Part III – Schedule of nonexempt transactions.
- Schedule H, Line 4a – Schedule of delinquent contributions.
- Schedule H, Line 4i – Schedule of assets held for investment purposes at the end of the plan year.
- Schedule H, Line 4i – Schedule of assets acquired and disposed of during the year.
- 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 for at the End of the Plan Year)			
AS OF DECEMBER 31, 20X5		EIN: 01-0000000 – PLAN NUMBER: 005	
(a)	(b)	(c)	(e)
Party in Interest	Identity of issuer, borrower, lessor or similar party	Description of investment including maturity date, rate of interest, collateral, par or maturity value	Current Value

Schedule H, Line 4J – Schedule of Reportable Transactions								
AS OF DECEMBER 31, 20X5					EIN: 01-0000000 – PLAN NUMBER: 005			
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Identity of Issuer, Borrower, Lessor, or Similar Party	Description of Investment Including Maturity Date, Rate of Interest, Collateral, Par or Maturity Value	Purchase Price	Selling Price	Lease Rental	Expense Incurred with Transaction	Cost	Current Value	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.

Schedule H, Line 4A – Schedule of Delinquent Contributions				
DECEMBER 31, 20X5			EIN: XX-XXXXXXX – PLAN NUMBER: 001	
<u>Total that Constitute Nonexempt Prohibited Transactions</u>				
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

Department of Labor rules require that the employer deposit deferrals to the trust as soon as the employer can; however, in no event can the deposit be later than the 15th business day of the following month. Remember that the rules about the 15th business day are not a safe harbor for depositing deferrals; rather, that these rules set the maximum deadline. (Deferrals include repayments of outstanding participant notes receivable.)

If the plan sponsor does not make the deposits timely, the failure may constitute both an operational mistake, giving rise to plan disqualification (if the plan specifies a date by which the employer must deposit elective deferrals) and a prohibited transaction. Although an employer can correct an operational mistake under EPCRS, a prohibited transaction cannot be corrected under EPCRS. However, the DOL maintains a Voluntary Fiduciary Correction Program (VFCP) that may be used to resolve the prohibited transaction.

If the plan sponsor fails to remit the deposits in a timely manner, then the untimely remittances must be:

- Disclosed in the financial statements;
- Reported on Schedule H, Line 4a;
- Presented on the supplemental schedule of delinquent contributions;
- Pay the 15 percent excise tax on the prohibited transaction; and
- Make up for the lost earnings for the period of time the deposits were delinquent.

Note:

Untimely remittances must continue to be reported on the supplemental schedule of delinquent contributions until they have been corrected, and this includes correction of the lost earnings.

The Employee Retirement Income Security Act of 1974 (ERISA) requires a plan's financial statements to include financial statement disclosures of reconciling differences, if any, between amounts reported in the financial statements and the amounts reported in Form 5500. If, upon reading Form 5500 subsequent to the issuance of the plan's financial statements the auditor identifies any such differences, he or she may consider reissuing the auditor's report, dual-dated with respect to the note explaining the differences.

III. Subsequent events

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 make sure 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. 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:

- Plan amendments;
- Change in custodian;
- Change in investment offerings;
- Plan mergers or acquisitions; and
- Plan termination.

FASB ASC 855-10, *Subsequent Events*, and AU-C §560, *Subsequent Events and Subsequently Discovered Facts*, establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued, and address the auditor's

responsibilities relating to subsequent events. Auditors are required to include this disclosure regardless of whether or not any subsequent events were recognized or disclosed in the financial statements. Note that FASB ASC 855-10 did not change the accounting from that previously applied but rather enhances disclosure. The following audit procedures may be required or may be applied for all employee benefit plans. Please note that this list is not all-inclusive and may be modified based on the auditor's judgment and circumstances of the engagement:

- Obtain an understanding of any procedures that management has established to make sure that subsequent events are identified.
- Review minutes of committee meetings through the date of the auditor's report.
- Obtain supplemental legal representations if there is a significant period between the date of the plan's legal counsel's response and the date of the auditor's report.
- Obtain the plan's interim financial statements (trustee or recordkeeper statements) for a period subsequent to the audit date, if any, and compare them with the financial statements being audited; investigate any unusual fluctuations.
- Inquire of and discuss with the plan administrator or other parties performing the plan's management function the following:
 - Unusual disposal or purchase of investments since year-end.
 - Mergers or spin-offs of plan assets.
 - Amendments to the plan and trust instruments and insurance contracts.
 - Matters involving unusual terminations of participants, such as termination arising from a sale of a division or layoffs.
 - Changes in plan commitments or contingent liabilities.
 - Adverse financial conditions of plan sponsor.
 - Any review or inquiry by the DOL, the IRS, or other regulatory agency of the plan's activities or filings since the last audit. (A review or inquiry might arise, for example, from enforcement activities, a request for an advisory opinion, or a request for a prohibited transaction exemption.)

The following are examples of financial statement disclosures for subsequent events:

Subsequent Events:

For the year ended December 31, 20X3, the Company has evaluated subsequent events for potential recognition and disclosure through 20X4, the date the financial statements were available to be issued.

Plan Merger:

Effective February 12, 20X3, the plan sponsor merged the plan into an existing plan sponsored by Acquiring Company and discontinued contributions to the plan, subject to the provisions of ERISA. As a result of this merger, net plan assets of \$244,133,126 were transferred to Acquiring Company 401(k) plan & trust on February 12, 20X3.

Plan Amendment:

On April 16, 20X3, 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 became effective May 1, 20X3.

The auditor should inquire of plan sponsor and other pertinent personnel regarding their knowledge of events and other information that occurred subsequent to the plan's year-end.

IV. 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 §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 §103(a)(3)(C) audit, acknowledgement that management's election of the ERISA §103(a)(3)(C) audit does not affect its responsibility for the financial statements and for determining whether:
 - i. An ERISA §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.

V. 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 §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 §260.
- 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 §265, *Communicating Internal Control Related Matters Identified in an Audit*.

The auditor should prepare audit documentation in accordance with AU-C §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 §§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.

VI. Communications with those charged with governance

Auditors have a responsibility to communicate with those charged with governance regardless of the plan's governance structure or size, in accordance with AU-C §260, *The Auditor's Communication With Those Charged With Governance*. Communications required by AU-C §260 are applicable regardless of a plan's governance structure or size; however, particular considerations apply when all of those charged with governance are involved in managing a plan. The auditor should communicate with those charged with governance on a timely basis.

The objectives of the auditor are to:

- Communicate clearly with those charged with governance the responsibilities of the auditor regarding the financial statement audit and an overview of the planned scope and timing of the audit.
- Provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process.
- Promote effective two-way communication between the auditor and those charged with governance.

Auditors should communicate with those charged with governance the planned scope and timing of the audit, qualitative aspects of the plan's significant accounting practices, the significant findings or issues from the audit, the significant difficulties, if any, encountered during the audit, disagreements with management, if any, and other findings or issues that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process.

The communication between the auditor and those charged with governance should be in writing if the auditor deems oral communication insufficient. If there were matters communicated during the course of the audit and resolved in a satisfactory manner, then those matters do not need to be reiterated at the

completion of the audit. Due to the fact that this communication is considered a by-product of the audit report then the auditor should clearly indicate that the communication is intended solely for the information and use of those charged with governance and if appropriate, management.

VII. Communicating internal control related matters identified in an audit

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control 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 internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process, but also at any other stage of the audit. AU-C §265, *Communicating Internal Control Related Matters Identified in an Audit*, specifies which identified deficiencies the auditor is required to communicate with those charged with governance and management.

Nothing in this section precludes the auditor from communicating to those charged with governance or management other internal control matters that the auditor has identified during the audit.

For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Deficiency in internal control – 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 deficiency in *design* exists when:

- A control necessary to meet the control objective is missing, or
- An existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when:

- A properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

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

Significant deficiency – 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.

The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.

The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate with those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.
- In writing or orally, other 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. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

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 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.
- A statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- 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.
- The definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- Identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- An explanation of the potential effects of the significant deficiencies and material weaknesses identified to enable appropriate remedial action, as required by AU-C §265, *Communicating Internal Control Related Matters Identified in an Audit*.
- 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.

Discussion question:

What are some of the common internal control deficiencies that you have identified in a 401(k) audit?

Common internal control deficiencies noted for an employee benefit plan include but are not limited to the following (please note that this list is not all inclusive).

Examples of circumstances that may be significant deficiencies or material weaknesses include:

- Inadequate design of controls over a significant account or process or in the preparation of the financial statements:
 - Improper valuation of investments, especially alternative investments.
 - Lack of controls over plan mergers and spin-offs, plan terminations, and liquidation accounting.
 - Lack of controls over accounting for plan amendments.
 - Lack of controls when changing service organizations and ensuring proper information has been transferred to the new service organization.
 - Failure to properly present and disclose investments (such as securities lending activities, master trusts, and alternative investments).
 - Inappropriate accounting and disclosure for allocated and unallocated contracts.
 - Lack of controls related to timely remittance of employee deferrals.
- Insufficient control consciousness within the organization:
 - 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.
 - Investing in alternative or complex investments without proper due diligence or consideration for the accounting, reporting, or regulatory requirements.
 - 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.
 - For multiemployer plans, improper monitoring of cash received from contributing employers.
 - Plan sponsor does not maintain sufficient records to support transactions that occur in plan operation and administration.

VIII. Plan tax qualification status

Auditors are not required or expected to be experts on the IRC. However, an auditor should possess sufficient knowledge of matters affecting employee benefit plans. This knowledge includes understanding the applicable sections of the IRC.

In accordance with the IRC, a benefit plan can be a qualified plan and receive favorable tax status for the earnings on plan investments to be exempt from taxation. A qualified plan is established by an employer to provide retirement benefits for its employees and their beneficiaries.

In order for a plan to maintain its tax-exempt status, the plan must comply with the provisions of the IRC. The plan document must satisfy the requirements of the IRC as well as follow those provisions. Employers should establish practices and procedures to ensure the plan is operated in accordance with the plan document, so participants and beneficiaries receive their proper retirement benefits.

To determine that a plan is operating within the specific guidelines established by the plan document in accordance with the IRC, certain nondiscrimination and other compliance tests are required to be performed at least annually. Many plan sponsors hire a third-party administrator to perform these tests (often the same party contracted to do the plan's recordkeeping). Examples of IRC requirements with which a plan must comply in order to maintain its tax-exempt status are presented in the following table.

Type of Test	Applicable to Defined Contribution Plans
Minimum coverage test (I.R.C. §410[b])	Yes
Nondiscrimination test (I.R.C. §§401[a][4] or 505)	Yes ^(a)
Average deferral and contribution percentage limits (I.R.C. §401[k] and [m])	Yes
Top-heavy tests (I.R.C. §416)	Yes ^(b)
Diversification rules for employee stock ownership plans (ESOPs) (I.R.C. §401[a][28])	Yes – ESOP plans only
Benefit and contribution limits (I.R.C. §415[b] and [c])	Yes
Employee deferral contribution limitations (I.R.C. §402[g])	Yes
Minimum funding obligations (I.R.C. §§412 or 430)	Only for money purchase pension plans
Unrelated business income tax (I.R.C. §§419A and 511)	Yes ^(c)
(a) Collectively bargained plans are deemed to automatically satisfy this test. (b) Plans with no key employees and collectively bargained plans are deemed to automatically satisfy this test. (c) If plan assets are invested in other than typical passive investments (for example, hedge funds, partnerships, or real estate investments), there may be unrelated business income tax considerations.	

Qualified employee benefit plans are subject to annual compliance testing including minimum participation requirements, minimum coverage requirements, and minimum vesting requirements. The tests themselves can be complicated and include various parameters. Plan auditors are not required to perform these tests or to recalculate the findings. However, plan auditors should be able to review the annual tests to determine whether or not the information provided to the service organization responsible for performing the calculations is accurate. If the service organization is given information that is incomplete or inaccurate then the tests cannot be relied upon.

The auditor should request a copy of the annual compliance testing from the plan sponsor or request this information directly from the service organization. Upon receipt, the following items should be examined by the auditor to evaluate the accuracy:

- Annual compensation.
- Participant contributions.
- Employer contributions.
- Catch-up contributions.
- Highly compensated individuals.
- Sections 402(g) and 415 limits for the current year.

Below are a few recommended procedures that auditors should consider when evaluating the annual compliance testing:

- Compare participant compensation to annual payroll reports;
- Reconcile the participant and employer contributions on the compliance test to the plan records;
- Identify the highly compensated individuals of the company; and
- Determine if the plan has passed or failed the compliance test.

In certain cases, a plan may not pass the required nondiscrimination tests for a given plan year. A plan may fail these tests for a variety of reasons (for example, excess contributions for or from highly compensated employees who participate in the plan). Once the plan administrators have been made

aware of the failure of a test, they may take corrective action, such as requiring an additional contribution or refunding excess contributions, so that the plan will then pass the nondiscrimination test.

In many cases, such refunds or additional contributions to participants occur after the end of the plan year currently under audit. If the plan administrator does not take the required corrective action to enable the plan to pass the required nondiscrimination tests, the auditor should consider the implications of this failure on the financial statements. These failures could jeopardize the plan's tax-advantaged status; however, the IRS has established a relief program to protect the plan's tax-advantaged status in most circumstances.

IX. Initial audit considerations

AC-C Section 510, *Opening Balances – Initial Audit Engagements, Including Reaudit Engagements*, this section addresses the auditor's responsibilities relating to opening balances in an initial audit engagement, including a reaudit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period such as contingencies and commitments. AU-C §510 contains a presumptively mandatory requirement for the auditor to read the most recent financial statements for information relevant to opening balances, including disclosures, and consistency in the application of accounting policies.

The objective of the auditor, in conducting an initial audit engagement, including a reaudit engagement, is to obtain sufficient appropriate audit evidence regarding opening balances about whether:

- Opening balances contain misstatements that materially affect the current period's financial statements; and
- Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements.

The auditor should read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures, and consistency in the application of accounting policies.

In instances in which the prior period financial statements were audited by a predecessor auditor, the auditor should request management to authorize the predecessor auditor to allow a review of the predecessor auditor's audit documentation and for the predecessor auditor to respond fully to inquiries by the auditor, thereby providing the auditor with information to assist in planning and performing the engagement.

The auditor should obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- a. Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
- b. Determining whether the opening balances reflect the application of appropriate accounting policies; and
- c. Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances and performing one or both of the following:
 - i. When the prior year financial statements were audited, reviewing the predecessor auditor's audit documentation to obtain evidence regarding the opening balances.
 - ii. Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor should communicate the misstatements to the appropriate level of management and those charged with governance, in accordance with Section 260, *The Auditor's Communication With Those Charged With Governance*.

The auditor should obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements and whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the plan has been previously audited, the successor auditor communicates with the predecessor auditor in accordance with the requirements of AU-C §210. Paragraphs .11-.12 of AU-C §210 state that before accepting an engagement for an initial audit, including a reaudit engagement, the auditor should request management to authorize the predecessor auditor to respond fully to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement. If management refuses to authorize the predecessor auditor to respond or limits the response, the auditor should inquire about the reasons and consider the implications of that refusal in deciding whether to accept the engagement. The auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response, in determining whether to accept the engagement. Paragraph .A31 of AU-C §210 states that the communication with the predecessor auditor may be either written or oral. Matters subject to the auditor's inquiry of the predecessor auditor may include:

- a. Information that might bear on the integrity of management.
- b. Disagreements with management about accounting policies, auditing procedures, or other similarly significant matters.
- c. Communications to those charged with governance regarding fraud and noncompliance with laws or regulations by the entity.
- d. Communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control.
- e. The predecessor auditor's understanding about the reasons for the change of auditors. (The DOL also requires that auditor changes and the reason for the change be reported on Form 5500, Schedule C, *Service Provider Information*.)

Areas of special consideration in an initial audit of a plan's financial statements include the completeness and accuracy of participant data and records of prior years, especially as they relate to:

- Participant contributions and eligibility.
- The amounts and types of benefits.
- The eligibility for benefits.
- Participant account balances.

According to Technical Questions and Answers Section 6933.01:

In an initial audit of a plan which has been in existence in previous years, ERISA requires that the audited financial reports contain a comparative Statement of Net Assets Available for Benefits and, as such, there should be some consideration of the accumulation of data from prior years, and the effect on current year balances. The auditor can choose to compile, review, or audit the opening Statement of Net Assets Available for Benefits. It is important to note, however, that if the opening Statement of Net Assets Available for Benefits is not audited, the auditor must satisfy himself or herself as to the reasonableness of the amounts reported in that statement because material errors in that information may materially impact the Statement of Changes in Net Assets Available for Benefits under audit.

The auditor should apply appropriate audit tests and procedures to the opening balances in the Statement of Net Assets Available for Benefits to determine that those balances are not materially misstated. The auditor should make inquiries of the plan's management and outside service organizations, as applicable, regarding the plan's operations during those earlier years. The auditor also may wish to obtain relevant information (for example, trust statements, recordkeeping reports, reconciliations, minutes of meetings, and service auditors' reports issued under SSAE No. 16, *Reporting on Controls at a Service Organization*, or Statement on Auditing Standards No. 70, *Service Organizations*, as amended (now superseded), for earlier years, as applicable, to determine whether there appears to be any errors during those years that could have a material effect on current year balances. Further, the auditor should gain an understanding of the accounting practices that were followed in prior years to determine that they have been consistently applied in the current year. Based on the results of the auditor's inquiries, review of relevant information, and evidence gathered during the current year audit, the auditor would determine the necessity of performing additional substantive procedures (including detailed testing or substantive analytics) on earlier years' balances.

The nature, timing, and extent of auditing procedures performed by the auditor are a matter of judgment and will vary with such factors as the adequacy of prior plan records, the significance of beginning balances, and the complexity of the plan's operations.

Planning the nature, timing, and extent of further audit procedures depends on the outcome of the auditor's risk assessment procedures. The following is a list of factors (not all-inclusive) that the auditor may want to consider when performing the risk assessment procedures for an initial audit of an employee benefit plan:

- a. Number of years the plan has been in existence.
- b. Longevity and competency of plan management.
- c. Complexity and adequacy of internal control structure, including contribution remittance policies and procedures and distribution policies and procedures.
- d. Complexity of plan provisions.
- e. Complexity of benefit calculations.
- f. Adequacy and organization of critical plan documents.
- g. Adequacy of plan records (participant data, payroll, census, or recordkeeper).
- h. Completeness of plan assets (all current and former participant accounts included as plan assets).
- i. Number and longevity of service providers.
- j. Monitoring of service providers (availability of Type 2 SOC 1 reports and complementary user controls).
- k. Accuracy of historical accounting estimates.
- l. Regulatory compliance matters.
- m. Valuation of investments without a readily ascertainable market value.
- n. Identified accounting policies that are not in accordance with GAAP.
- o. Fraud risks.
- p. Going concern.
- q. Litigation, claims, and assessments.
- r. Related party and party in interest transactions.
- s. Prohibited transactions.
- t. Nondiscrimination testing.
- u. Material weaknesses or significant deficiencies.
- v. Plan transfers (plan mergers, spin-offs, or other transfers).

Paragraph .A17 of AU-C §510 states that the inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in a qualified opinion or disclaimer of opinion, as is appropriate in the circumstances.

X. Plan transfers (mergers and acquisitions) and terminations

A. Plan mergers

Generally, the purchase of one company by another (merger) can impact the retirement plans maintained by one or both of the companies as follows:

- **Post-merger company becomes new plan sponsor** – If only one company in the merger transaction had a retirement plan, the new post-merger company may become the sponsor of that retirement plan.
- **One company may merge its retirement plan with that of the other company** – This results in the post-merger company having only one retirement plan covering all employees.
- **Either one or both of the companies may terminate their retirement plan** – This can result in:
 - No retirement plan for the post-merger company;
 - One company in the merger terminates its retirement plan and then allows the participants of the terminated plan to join the retirement plan of the post-merger company; or
 - Both companies in the merger terminate their plans and the post-merger company starts a new plan.

1. Post-merger company becomes new plan sponsor

If only one company in the transaction had a retirement plan, the post-merger company can decide to become the new sponsor of that plan. Generally, a new plan sponsor does not significantly change the terms of the existing plan and, therefore, has little impact on existing plan participants.

The law does require that the new sponsor notify the plan's participants of the new plan sponsor's name and address.

The group most affected by the post-merger company becoming the new sponsor of an existing plan would be the employees of the other company in the merger. These employees would likely have the opportunity to join that retirement plan as long as they meet that plan's eligibility requirements.

A retirement plan can merge with another plan. Generally, the merger of the plans cannot violate the *anti-cutback rule*. This means that the merger cannot reduce or eliminate protected benefits:

- Accrued benefits;
- Early retirement benefits;
- Retirement-type subsidies; or
- Optional forms of benefit.

Although a plan merger may result in some changes in a plan's administrative terms (for example, the plan administrator or investment choices), it usually does not have a significant impact on a participant's benefits.

The auditor may identify the occurrence of plan transfers through inquiry or by reviewing the provisions of the plan document, plan amendments, board resolutions, or minutes. Plan transfers may be permitted or

required by the provisions of the plan or may be a nonrecurring event that is typically included as a plan amendment, for example, the result of a merger or spin-off. A spin-off occurs when certain individual participant accounts associated with the participants of a plan are transferred to a new plan or a plan of another company. This may occur, for example, when a plan sponsor sells or sets up a new corporation for a certain division of employees.

Identifying a plan transfer may be challenging because the reports provided by the trustee or custodian may classify the transfer as a conversion, miscellaneous adjustment, or as contributions or distributions, rather than a plan transfer. Further, the date at which the plan's assets physically transfer (assets move from the predecessor plan's trust to the successor plan's trust) may differ from the effective date of the transfer (the date at which the plan assets are legally transferred to the control of another plan, according to relevant plan amendments, or other documents). For example, a plan transfer may have an effective date during the current reporting period, but the assets may not physically transfer and may not be recorded by the successor trustee or custodian until the subsequent reporting period. This may require obtaining trust information from more than one trustee or custodian. Also, the assets may physically transfer in multiple transactions.

The effective date of the transaction and the appropriate period to record the plan transfer will typically be identified in plan amendments and merger documentation. FinREC recommends that the net assets transferred into or out of the plan be recorded on the statement of changes in net assets available for benefits after the net increase or decrease for the period.

B. Plan termination

If a company decides to terminate its retirement plan, it generally:

- Notifies all plan participants; and
- If allowed, distribute its assets to the plan participants as soon as administratively feasible (generally, within one year).

Upon full or partial termination, affected participants become 100 percent vested in their account at the termination date regardless of the plan's vesting schedule.

1. Partial plan termination

The plan may have a partial termination if more than 20 percent of total plan participants were laid off in a particular year. Partial terminations can occur in connection with a significant corporate event such as a closing of a plant or a division, or as a result of general employee turnover due to adverse economic conditions (downsize) or the termination of a product line or other reasons that are not within the employer's control. The reduction can accumulate over one or more plan years and still be classified as a partial termination.

The law requires all "affected employees" to be fully vested in their account balance as of the date of a full or partial plan termination. They must become 100 percent vested in all employer contributions (including matching contributions) regardless of the plan's vesting schedule. Employee salary deferrals are always 100 percent vested.

An affected employee in a partial termination is generally anyone who left employment for any reason during the plan year in which the partial termination occurred and who still has an account balance under the plan. Some plans wait until an employee has five consecutive one-year breaks in service before he or she forfeits their nonvested account balance. For these plans, employees who left during the plan year of

the partial termination and who have not had five consecutive one-year breaks in service are affected employees.

A partial termination may occur due to a plan amendment that excludes employees or adversely affects vesting.

Example: A plan amendment that excludes certain categories of employees from further participating in the employer's plan, resulting in the exclusion of 120 out of 170 participants, is deemed a partial termination.

Routine turnover during the year is generally not considered a partial termination.

Factors relevant to determining whether the turnover rate is routine include:

- Information on the turnover rate in other periods and the extent to which terminated employees were actually replaced;
- Whether the new employees performed the same functions;
- Whether the new employees had the same job classification or title; and
- Whether the new employees received comparable compensation.

Generally, voluntary terminations do not count in determining whether a partial termination has occurred as they do for determining who must vest after partial termination. However, in some cases employees who appear to terminate employment voluntarily have been found to have terminated involuntarily under a constructive discharge theory. The employer's intent, working conditions, and the reasonably foreseeable impact of the employer's conduct on the employees are factors in evaluating a constructive discharge.

An employer who partially terminates a plan must determine which participants require an acceleration of vesting due to the partial termination. Participants who improperly incurred forfeitures are owed more benefits. To the extent those forfeitures have been distributed to other participants and cannot be recovered, the employer will be responsible for making the affected participants whole. This vesting failure can be corrected using the Voluntary Correction Program.

Auditors should be familiar with the partial plan termination rules in order to be determine if distributions from the plan were in accordance with the rules and regulations.

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. This has been a substantial area of concern for many employers implementing workforce reductions in response to the COVID-19 pandemic.

2. Full plan termination

A plan termination requires more than deciding to discontinue the plan.

The IRS considers a 401(k)-plan terminated only if:

- The **date of termination** is established (this can take the form of a plan amendment, board of directors' resolution, or complete discontinuance of contributions);
- The **benefits and liabilities under the plan are determined** as of the date of plan termination; and
- All **assets are distributed** as soon as administratively feasible, generally within one year after the date of plan termination.

A 401(k) plan that has not distributed its assets as soon as administratively feasible is considered an ongoing plan and must continue to meet the qualification requirements, including amending the plan document for law changes. If you maintain another plan, you may have to transfer employees' elective deferral accounts to the other plan rather than distributing them to employees.

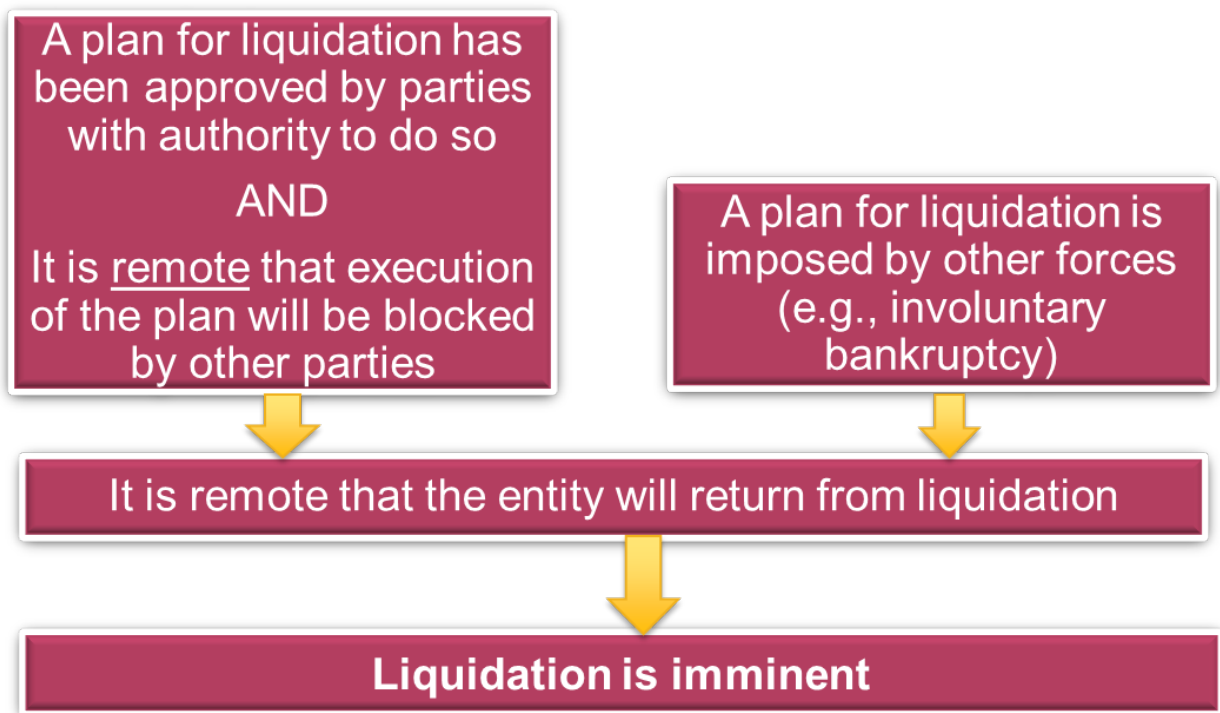
When a decision has been made to terminate the plan, the relevant circumstances should be disclosed in all subsequent financial statements issued by the plan.

If the liquidation of a plan is deemed to be imminent (as defined in FASB ASC 205-30-25-2) before the end of the plan year, the plan's year-end financial statements should be prepared using the *liquidation* basis of accounting in accordance with FASB ASC 205-30. Plan financial statements for periods ending after the determination that liquidation is imminent are prepared using the liquidation basis of accounting.

Determining whether liquidation is imminent is a matter of judgment, based on facts and circumstances. In accordance with FASB ASC 205-30-25-2, liquidation is imminent when either of the following occurs:

- a. A plan for liquidation has been approved by the persons with authority to make such a plan effective, and the likelihood is remote that any of the following will occur:
 - i. Execution of the plan will be blocked by other parties.
 - ii. The entity will return from liquidation.
- b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

For a single-employer DC plan, this means that the likelihood would need to be remote that other parties, such as the IRS, would block the liquidation. Such evaluation often depends on whether the termination is a standard termination, or a distressed or involuntary termination.



Financial statements prepared using the liquidation basis of accounting should present an entity's expected resources in liquidation by measuring and presenting assets at the amount of the expected cash proceeds from liquidation. The entity should include in its presentation of assets any items it had not previously recognized under U.S. GAAP, but that it expects to either sell in liquidation or use in settling liabilities.

In accordance with FASB ASC 205-30, the entity should recognize and measure its liabilities in accordance with GAAP that otherwise applies to those liabilities. The entity should not anticipate that it will be legally released from being the primary obligor under those liabilities, either judicially or by creditor(s). The entity also is required to accrue and separately present the costs that it expects to incur and the income that it expects to earn during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities. Additionally, FASB ASC 205-30-25 requires disclosure about an entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process.

An entity shall disclose all of the following when it prepares financial statements using the liquidation basis of accounting:

- a. That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the entity's determination that liquidation is imminent.
- b. A description of the entity's plan for liquidation, including a description of each of the following:
 - i. The manner by which it expects to dispose of its assets and other items it expects to sell that it had not previously recognized as assets (for example, trademarks).
 - ii. The manner by which it expects to settle its liabilities.
 - iii. The expected date by which the entity expects to complete its liquidation.
- c. The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those methods and assumptions.
- d. The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned.

5. A is **incorrect**. Management letter comments are not required to be communicated to those charged with governance unless they rise to the level of a significant deficiency or material weakness.
- B is **incorrect**. Deficiencies in design of a control that are deemed insignificant in nature do not require communication to those charged with governance.
- C is **incorrect**. Deficiencies in the implementation of a control that are deemed insignificant do not require communication to those charged with governance.
- D is **correct**. An identified deficiency in internal control (design or implementation) that warrants the attention of management should be communicated to those charged with governance.
6. A is **correct**. Annual compliance testing does not involve or require reconciling distributions to the Form 1099s.
- B is **incorrect**. The auditor should identify the highly compensated individuals to ensure proper treatment on the annual compliance tests.
- C is **incorrect**. The plan should distribute excess contributions in a timely manner in order to maintain tax status.
- D is **incorrect**. The auditor should determine that total participant contributions per the payroll records agree to the compliance tests.
7. A is **incorrect**. In an initial audit of a plan that has been in existence for several years, the auditor should obtain copies of trust statements, recordkeeper reports, and SOC reports for prior years.
- B is **incorrect**. The auditor should obtain an understanding of the accounting practices used in previous years in an initial audit to evaluate consistency.
- C is **correct**. Confirming participant balances with the plan sponsor would not be an appropriate audit procedure for an initial audit (or a continuing engagement).
- D is **incorrect**. The auditor should inquire of plan management and outside service providers to determine if there were any significant changes over the previous years.
8. A is **incorrect**. If a decision is made to terminate the plan before the plan's year-end, then this would indicate that liquidation is imminent and require the liquidation basis of accounting.
- B is **incorrect**. If there is a remote possibility that the execution of the plan for termination will be blocked, then liquidation is deemed imminent.
- C is **incorrect**. If there is a remote possibility that the entity will return from liquidation, then liquidation is deemed imminent.
- D is **correct**. If a decision is made to terminate the plan after the plan's year end, then a disclosure is all that would be necessary on the current year financial statements.

