

CHALLENGES AHEAD FOR ERISA AUDITS: THE “GREAT EIGHT”, SAS 114, FORM 5500

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You may be spending more time planning this year for Employee Retirement Income Security Act (ERISA) audits, thanks to several new standards.

For 2006 ERISA audits, the challenge was to obtain, in a timely manner, fair value information in accordance with SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies*.

For 2007 audits, the challenges are to understand the entity and its environment, including its internal control, to assess the risk of material misstatement and modify procedures accordingly, and to communicate with those charged with governance *before* fieldwork.

RISK ASSESSMENT STANDARDS

In March 2006, the American Institute of CPAs (AICPA) Accounting Standards Board issued Statement on Auditing Standards (SAS) No. 104–111, known as the “Risk Assessment Standards.” The standards are effective for audits of financial statements for periods beginning on or after December 15, 2006.

While earlier application was permitted, many firms chose not to implement this series of standards, recently labeled the “great eight,” before their audits for the year ended December 31, 2007. According to the AICPA executive summary, the primary objective of these statements is to enhance the application of the audit risk model in practice.

The most significant changes to the usual procedures are:

- More extensive understanding of the entity and its environment
- More precise assessment of risks of material misstatement
- Mindful consideration of the assessed risks to determine nature, timing and extent of audit procedures

A brief summary of each of the eight standards follows:

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SAS 104, AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 1, CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (“DUE PROFESSIONAL CARE IN THE PERFORMANCE OF WORK”)

In the report of independent accountants, an auditor states that, excluding the investments certified by the trustee in a limited-scope audit, an audit has been conducted

in accordance with generally accepted auditing standards (GAAS). The full-scope auditor’s report specifies, “Those standards require that we plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatement.”

Due professional care involves planning and performing the audit “to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level that is, in his or her professional judgment,

appropriate for expressing an opinion on the financial statements.” This reasonable assurance is a high level of assurance, but is not absolute.

SAS 105, AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 95, GENERALLY ACCEPTED AUDITING STANDARDS

The second standard of fieldwork states, “The auditor must obtain a sufficient understanding of the *entity and its environment, including its internal control*, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.” The understanding obtained during audit planning is explicitly part of the risk assessment process, and the auditor designs *further audit procedures* based on that understanding.

Obtaining and reading the SAS 70 report of a plan’s recordkeeper is an efficient start, as many transactions are conducted online or by telephone. A generic approach to employee benefit plan audits is no longer acceptable. From the outset, the auditor determines whether basic procedures for each significant account balance and class of transactions are adequate, or if extended procedures are necessary, recognizing that audit evidence obtained could change the initial assessment.

SAS 106, AUDIT EVIDENCE

According to this standard, “Appropriateness is the measure of the quality of *audit evidence*, that is, its relevance and its reliability in providing support for, or detecting misstatements in, *the classes of transactions, account balances, and disclosures and related assertions*. Accordingly, the sufficiency and appropriateness of audit evidence are interrelated.”

Audit evidence encompasses all information the auditor uses to arrive at a conclusion, and it may be obtained by inspection of records or documents, observation, inquiry, confirmation, recalculation, reperformance or analytical procedures.

SAS 106 further describes how the auditor uses *relevant assertions* to assess risk. Classes of transactions that are relevant to an ERISA audit relate to activity in a participant’s account. Understanding of the payroll frequency and process may help assess the appropriateness of period-end cutoffs for participant contributions. Likewise, tracing relevant participant data, such as birth, hire and termination dates, etc., to personnel files covers all relevant assertions *except* cutoff: existence/occurrence, completeness, rights/obligations, accuracy/classification, and valuation/allocation. Account balances for a typical benefit plan that are material include investments and contributions receivable.

For a limited-scope audit, obtaining and reviewing a properly certified trustee statement covers *all* potential relevant assertions. Inspection of a subsequent trustee statement reflecting the collection of contributions receivable after year-end may provide audit evidence regarding both existence and valuation. Finally, the SAS specifies that in addition to the use of inquiry, the auditor should perform other audit procedures to obtain sufficient appropriate audit evidence. Repeat with me, “Inquiry alone is not sufficient to test the operating effectiveness of controls.”

SAS 107, AUDIT RISK AND MATERIALITY IN CONDUCTING THE AUDIT

Audit risk is defined as “the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.” As the title indicates, both audit risk and materiality are considered during risk assessment. The resulting term “risk of material misstatement” is the combined assessment of inherent risk and control risk. One immediately thinks in quantitative terms when discussing materiality, but there are also qualitative factors. Qualitative considerations for a defined benefit plan would include a misstatement that changes the regulatory funding requirements or changes the financial status of the plan from over- to under-funded.

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reassessment, resulting in further audit procedures. At the completion of the audit, all known and likely uncorrected misstatements are combined to determine whether or not they are material to the financial statements taken as a whole. SAS 107 also covers the communication and documentation of these misstatements.

SAS 108, *PLANNING AND SUPERVISION*

The first standard of fieldwork states, "The auditor must adequately plan the work and must properly supervise any assistants." The supervisory component has not changed much, but there is more emphasis on planning. Planning begins with engagement acceptance and continues with obtaining an understanding of the entity and its environment, including its internal control — but it is not over once fieldwork begins.

Determination of the overall audit strategy is part of planning. These details include scope, whether new regulations impact the plan whether the engagement is limited or full-scope, whether new regulations impact the plan and when the report will be delivered. The strategy is subject to revision based upon the gathering of sufficient appropriate audit evidence, or the inability to do so. For example, the inability to obtain fair value information in a timely manner in accordance with SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies*, affected the strategy of many audits for 2006. The audit plan is more detailed, and includes the nature, timing and extent of risk assessment and further audit procedures. The audit plan is also subject to revision, and the auditor should document any such revisions to the overall audit strategy or audit plan.

SAS 109, *UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT*

This SAS states, "Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit." During the gathering of information, risk assessment procedures include inquiries of management and others, observation, inspection and analytical procedures. Similar to the SAS 106 requirements, the auditor should perform an appropriate blend of all of these procedures, such as

walkthroughs of systems, not just inquiries. An auditor may use narratives, checklists, questionnaires and/or flowcharts to document the understanding.

SAS 109 further requires auditors to evaluate whether specified controls are capable of preventing and detecting or correcting material misstatements. When performing tests of controls, exceptions may indicate that controls are not operating effectively and further understanding and/or correction is needed.

SAS 110, *PERFORMING AUDIT PROCEDURES IN RESPONSE TO ASSESSED RISKS AND EVALUATING THE AUDIT EVIDENCE OBTAINED*

SAS 110 states, "Certain audit procedures may be more appropriate for some assertions than others." For example, tests of controls over participant contributions may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures, such as reconciling the client's schedule of remittances to the trustee statement, may be most responsive to the assessed risk of misstatement of the occurrence assertion.

For financial reporting, substantive procedures should include tests of details, such as agreeing the financial statements and notes to the underlying accounting records and examining adjustments made to that information. Another would be the use of a disclosure checklist to ensure completeness of disclosures specified by Generally Accepted Accounting Principles. For administrative expenses, a substantive analytical procedure, as opposed to a test of details, may be more appropriate, as these transactions tend to be predictable over time.

SAS 111, *AMENDMENT TO SAS 39: AUDIT SAMPLING*

This SAS provides guidance about establishing tolerable misstatement, in addition to guidance on the application of sampling to tests of controls. For an employee benefit plan, it has limited implications.

Appendix M of the AICPA Audit and Accounting Guide, *Employee Benefit Plans*, offers a comparison of the risk assessment standards to previous standards. In addition, the AICPA's Employee Benefit Plan Audit Quality Center (EBPAQC) at <http://ebpaqc.aicpa.org> hosted a live forum, "Applying the

Risk Assessment Standards in Employee Benefit Plan Audits,” on April 22, 2008, and the archive is available to Center members on the web site.

SAS 114, THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

The term “those charged with governance” refers to “those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity’s financial reporting process.” For an employee benefit plan, those charged with governance are likely to involve human resources personnel, in addition to accounting and finance personnel. Otherwise, the communication is not much different than for the audit of a business.

FORM 5500 CHANGES

The only 2007 revisions affecting a single-employer plan that requires an audit relate to Schedule B (Actuarial Information), which applies to defined benefit plans and money purchase defined contribution plans.

The 2007 Instructions for Schedule B, line 6d, reflect updated mortality tables and the list of codes used for valuation purposes as well as calculating current liability. In addition, the effects of the “unfunded mortality increase,” which is amortized over a period of 10 years beginning with the first plan year for which new mortality tables are applicable, are reported on lines 12g and 12j.

Not a lot of news is good news, especially considering the significant changes in store for 2009. That’s when Form 5500 filings must be filed electronically and ERISA-covered 403(b) Plans deemed “large” will require an audit.

CONCLUSION

These are just a few considerations for this year’s ERISA audits. Hopefully, every reader can benefit from at least one mentioned. Best wishes for a most efficient summer of ERISA audits!

RESOURCES

- *Statement on Auditing Standards No. 104–No. 111, Risk Assessment Standards*, American Institute of CPAs, www.aicpa.org/download/members/div/auditstd/riasai/RAS_Summary_for_Website.pdf
- AICPA Employee Benefit Plan Audit Quality Center (<http://ebpaqc.aicpa.org>)
- AICPA Audit and Accounting Guide, *Employee Benefit Plans*
- *AICPA Audit Risk Alert: Employee Benefit Plans Industry Developments — 2008*
- Practitioners Publishing Company (PPC) *Audits of Employee Benefit Plans*
- 2007 Instructions for Form 5500
- U.S. Department of Labor Employee Benefits Security Administration Web site: www.dol.gov/ebsa

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