Chapter 1

INTRODUCTION AND BACKGROUND

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LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recognize the basic features of 401(k) plans.
- Identify the general features of 401(k) plan operation and administration.
- Identify the general reporting requirements for 401(k) plans.

INTRODUCTION

This course has been prepared to assist the independent qualified public accountant in accounting, auditing, and reporting on financial statements of 401(k) defined contribution retirement plans. This course will help them identify the uniqueness of these types of audits.

Generally accepted auditing standards and generally accepted accounting principles apply in general to employee benefit plans. This course assumes that the user is generally knowledgeable in the field of accounting and auditing. Rather than discussing the broad application of those standards and principles, the course focuses primarily on the special issues involved in accounting, auditing, and reporting on financial statements of 401(k) employee benefit plans. The course does not discuss the application of all generally accepted accounting principles and auditing standards as they pertain to the auditing of general financial statements.

This course focuses on *single-employer* sponsored 401(k) plans. However, multiemployer sponsored 401(k) plans would be treated as single-employer plans for purposes of reporting to the regulatory agencies described in the following text.

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Background Information

A 401(k) plan may be incorporated into a profit-sharing, stock bonus, thrift, or savings plan. A 401(k) plan gives participants the option of receiving a cash payment immediately (salary) from the employer (taxable) or having the cash contributed to the plan as contributions on the participant's behalf (tax -deferred). Government and not-for-profit entities have 403(b) plans that are similar in nature to the 401(k) plans. Although this course does not specifically address governmental plans, certain auditing procedures discussed herein might be helpful to the auditor of governmental plans. Certain 403(b) plans (primarily those with 100 or more participants) have an audit requirement. There is a separate AICPA course offered for 403(b) plans, *Audits of 403(b) Plans*.

Multiemployer plan considerations:

A 401(k) plan may be sponsored by a single employer, multiple employers, or under a multiemployer arrangement. The majority of 401(k) plans are single-employer plans; however, you should be aware of the existence of multiemployer plans. The most basic distinction between single and multiemployer plans is how they are administered. Single-employer plans are generally established and operated by the management of one employer or a controlled group of corporations, called the *plan sponsor*. In contrast, multiemployer plans are typically established through collective bargaining agreements negotiated between a group of employers (such as construction) and the union representing the employees. These plans are managed by a joint employer or union board of trustees.

The various types of defined contribution plans that 401(k) plans are typically part of are briefly described in the text that follows. Such plans can permit employee contributions. The distinguishing characteristic of the plans is often how the sponsor contribution is derived or treated.

- A profit-sharing plan is a defined contribution plan that is not a pension plan (as defined in the Internal Revenue Code) or a stock bonus plan. It is a plan in which the sponsor contributes money to participants' accounts either on a discretionary basis (that is, not mandatory) or as a percentage of profits, compensation, or other factors. A profit-sharing plan must be designated as such in the plan document.
- A stock bonus plan is a defined contribution plan in which employer contributions to the plan are normally made in the stock of the employer. If stated in the plan document, the participant may request to be paid in cash instead of employer stock.
- A thrift or savings plan is a profit-sharing or stock bonus plan whereby participants make contributions to the plan from after-tax dollars. Employee contributions are often matched by the sponsor, either in whole or in part.

When participants elect to contribute to a 401(k) plan, they agree to have a portion of their wages before income taxes contributed to specific investments. These contributions are taken out of their wages and invested in the investment option(s) offered by the plan and selected by the participant. Plans also may provide for after-tax contributions, or may offer a Roth 401(k) feature, in which contributions are made on an after-tax basis.

The pre-tax deductions that the participant makes are called deferrals and are generally calculated as a percentage of total compensation. In other words, for each payroll cycle, the stated percentage amount is deducted from the participant's gross income before taxes are withheld and this money is then invested in the 401(k) plan. The employee can change the deferral rates periodically as permitted by the plan

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document. Many plans now have automatic enrollment or the ability for participants to change their contribution percentage via an online system.

Defined contribution plans require that a separate account be maintained for each participant. This provides the participant with information as to total dollars in his or her account and the allocation of those dollars among the various investment options. Each individual participant account is maintained within the plan. In a 401(k) plan, generally, participants direct the selection of investments in their account and bear the investment risk of their individual account. The value of a participant's account fluctuates according to (*a*) amounts contributed to the account by the sponsor or participant (or both), (*b*) investment experience on such amounts, (*c*) participant-initiated withdrawals, (*d*) expenses, and (*e*) any forfeitures allocated to the account. Many plans permit a participant to withdraw a portion of his or her account in the form of a loan from the plan. Loans by participants are treated as receivable of the plan. (See chapter 4 for further information.) Withdrawals from the plan can be made according to the plan provisions when an employee terminates employment, retires, or is eligible for a hardship withdrawal.

Under a defined contribution plan, the sponsor contribution rate is generally determined periodically at the discretion of the sponsor or by contractual agreement, or both. When a participant retires or withdraws from the plan, the amount allocated to the participant's account, the vested amount, represents the participant's accumulated benefits. Participants are always fully vested in the amount of their employee contributions. The vested amounts of a participant's account balance may be paid to the participant or used to purchase a retirement annuity. (Vesting will be discussed in more detail in chapter 5.)

Multiemployer plan considerations:

A multiemployer plan is a pension or postretirement benefit plan (to which more than one employer is required to contribute) that is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer. A multiemployer plan is usually administered by a board of trustees composed of management and labor representatives and may also be referred to as a joint trust or union plan. Multiple employer plans are plans that are maintained by more than one employer but not treated as a multiemployer plan. Multiple employer plans are generally not collectively bargained and are intended to allow participating employers to pool their assets for investment purposes and to reduce the costs of plan administration. A multiple employer plan maintains separate accounts for each employer so that contributions provide benefits only for employees of that contributing employer. Generally, many employers participate in a multiemployer or multiple employer plan, and an employer may participate in more than one plan. The employers participating in multiemployer plans usually have a common industry bond—but for some plans, the employers are in different industries and the labor union may be their only common bond. Multiple employer plans do not involve a union. For example, local chapters of a not-for-profit entity may participate in a plan established by the related national organization. Although this course does not specifically address multiemployer or multiple employer plans, certain auditing procedures herein address multiemployer or multiple employer plans and might be helpful to the auditor of multiemployer or multiple employer plans. For a resource reference, see the publication "Payroll Auditing—A Guide for Multiemployer Plans" by Beebe and Vivirito, published by the International Foundation of Employee Benefit Plans.

A 403(b) plan is a retirement savings arrangement sponsored by certain not-for-profit organizations (such as hospitals and private colleges) and public schools. The 403(b) plans are defined contribution plans

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with individual salary deferral limits that are similar, but not identical, to 401(k) programs. Contributions to a 403(b) plan typically include employee salary deferrals. Not-for-profit organizations often times establish a 401(a) plan that funds employer-matching contributions to a 403(b) plan. Auditors should obtain an understanding of the deferrals made under the 403(b) plan in order to determine if the employer match under the 401(a) plan is properly determined. Investments for funding these 403(b) arrangements are restricted by law to annuity contracts (403[b][1] arrangements) or custodial accounts holding the shares of regulated investment company stock (for example, mutual funds) (403[b][7] arrangements). All 403(b) plans are subject to the same Form 5500 reporting and audit requirements that currently exist for Section 401(k) plans. For large 403(b) plans, as defined by the Employee Retirement Income Security Act (ERISA), reporting requirements include not only the completion of the entire Form 5500 but also the engagement of an independent qualified public accountant to conduct an independent audit of the plan. Although this course does not specifically address 403(b) plans, certain auditing procedures herein might be helpful to the auditor of 403(b) plans. There is a separate AICPA course offered for 403(b) plans, *Audits of 403(b) Plans.*

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Operation and Administration

A 401(k) plan is contributory, with contributions from both employers and participants or from participants only. Contributions from employers may be discretionary or may be required.

A defined contribution plan is established by the plan document and relevant plan provisions are detailed in the plan document. These provisions are established and maintained by the plan sponsor. They define such matters as age and service requirements, which must be satisfied to allow an employee to participate in the plan, vesting, and loans. They also identify the plan's fiduciary(ies), fiduciary responsibilities (those relating to maintaining control and management of the plan), and the delegation of fiduciary responsibilities in connection with the administration of the plan. A plan subject to the Employee Retirement Income Security Act of 1974 (ERISA) must be in writing. Sponsoring organizations, such as banks, insurance companies, or stock brokers, prepare and update standard plans called master or prototype plans that are available to a plan sponsor to enable the plan sponsor to establish a qualified plan by customizing a standard plan to meet the plan sponsor's needs. These standardized plans generally have IRS approval.

The named fiduciary is responsible for the general operation and administration of the plan in addition to identifying a plan administrator. The plan administrator of a single employer plan is usually an officer or other employee of the plan sponsor, whereas the plan administrator for a multiemployer plan generally is a board of trustees. The plan administrator reports directly to those charged with governance of the plan, which may be an oversight committee or the plan sponsor's board of directors or other management group. The fiduciary has responsibility to make sure that the plan is operating in accordance with the terms of the plan document, trust instrument, if any, and all applicable government rules and regulations. Generally, the fiduciary makes policy decisions concerning such matters as interpretation of the plan provisions, determination of the rights of the participants under the plan, how investments are to be managed, and the performance or the delegation of responsibilities for operating and administering the plan.

The ultimate responsibility for the oversight of the plan rests with the fiduciary. However, the plan's day-to-day administration (for example, collecting contributions, paying benefits, managing cash and investments, loan administration, maintaining records, and the preparation of reports) is often assigned to various entities such as (*a*) the plan sponsor; (*b*) a trustee, such as a trust department of a bank or insurance company; (*c*) an investment advisor; (*d*) a third-party administrator or recordkeeper; or (*e*) a person or persons designated as the plan administrator.

A plan usually has a trust instrument or agreement that details the authority and responsibilities of the trustee(s) and any investment advisors or managers. This document should include or be consistent with the plan's investment policy and therefore may restrict the investment options permitted by the plan. In addition, the trust agreement should describe the fees to be paid to the trustees, investment advisors, and managers for services provided to the plan. It also will describe who is responsible for payment of these services—that is, the participants or the plan sponsor.

The U.S. Department of Labor (DOL) has launched a campaign to educate plan sponsors regarding their fiduciary responsibilities under ERISA. As part of this campaign, the DOL has published several publications, including one entitled *Meeting Your Fiduciary Responsibilities*.

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KNOWLEDGE CHECK

1. The named fiduciary is not responsible for

   a. The identification of the plan administrator.
   b. The operation of the plan in accordance with the plan instrument.
   c. Day-to-day administration of the plan.
   d. Certifying investments.

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Accounting Records

Accounting records for a defined contribution plan should be maintained in a reliable manner so as to permit effective management and operation of the plan. Accounting records must be in a format that will make sure reliable financial reporting of the plan. The complexity of the plan will determine the nature of the accounting records and will vary with such factors as the frequency of sponsor contributions, the number of investment options available for participants to select, rules regarding the administration of loans, the variety of options available to terminated participants, and the delegation of administrative duties.

The various accounting and plan records of a 401(k) plan are often maintained at several locations. Depending on the nature of the plan, how fiduciary responsibilities are allocated, and who is responsible for various administrative duties, plan records may be maintained by various trustees, insurance companies, recordkeepers, the plan administrator, and the plan sponsor—including the payroll and human resources departments.

The records of the plans normally should include the following:

- *General accounting records*—Plans are required to maintain records of their receipts and disbursements; however, in many cases, they are prepared by the trustee, insurance company, or recordkeeper. Many times, general ledgers are not maintained by the plan sponsor:
  - Trust or custodian statements are maintained by the trust or custodian system and represent the books and records of the plan. These statements detail all receipts and disbursements, including investment transactions, during the period. The trustee or custodian system records contributions, earnings and losses, plan investments, expenses, and distributions.
  - Recordkeeper statements are maintained by the recordkeeping system and represent both the activity posted to each participant's account during the period, as well as a plan-level consolidation of all such activity. The recordkeeping system helps track and properly allocate contributions, earnings and losses, plan investments, expenses, and distributions in a participant's account.
- *Investment asset records*—ERISA requires detailed reporting of investment assets in addition to the supplemental schedules. The supplemental schedules include schedules of (*a*) assets (held at end-of-year); (*b*) assets (acquired and disposed of within year); (*c*) loans or fixed income obligations in default (*d*) leases in default or classified as uncollectible; (*e*) reportable (5 percent) transactions; and (*f*) nonexempt transactions. See chapter 6 for additional information on the contents of the supplemental schedules. These records are generally maintained by the trustee or custodian or plan sponsor (or a combination of these entities).
- *Participants' records*—Records should be maintained to determine each employee's eligibility to participate in the plan. Many plans have age and service requirements that the employee must satisfy before he or she is eligible to participate in the plan. Eligibility also can be affected by breaks in service (leaving the employment of the plan sponsor and then returning or taking long-term disability, for example). These records are generally maintained by the human resources and payroll departments at the plan sponsor or the administrative office of a third-party administrator for a multiemployer plan.
- *Contribution records*—Separate contribution records should be maintained for employee and sponsor contributions. The plan sponsor generally retains payroll records detailing employee contributions. Sponsor contributions should be accounted for separately to make sure that the contributions are being made in accordance with the plan document. As with participant contributions, the plan sponsor maintains records of sponsor contributions.

You should be aware that many plans accept contributions into a Roth IRA account. Contributions into a Roth IRA are made post-tax (after all federal and state taxes are withheld as opposed to a 401(k) contribution that is made pre-tax). However, subsequent distributions from a Roth IRA are not taxable to the participant (401(k) contributions are usually subject to tax upon distribution). Because of these differences, it is imperative that contributions to a Roth IRA and the related earnings on those contributions be maintained in a separate account so that the proper tax treatment can be made by the participant when those monies are distributed.

- *Distribution records*—Records of all distributions to participants (for persons who have left employment at the plan sponsor, retired, elected to cease contributing to the plan, and so on), including loans, should be maintained. These records will detail distribution amounts, payment schedule (lump sum or over a period of several years), payment commencement date, forfeitures (if any), and information to determine the tax consequences of the distribution to the participant.

  As mentioned earlier, separate records must be maintained if contributions to a Roth IRA were permitted. This will enable management to identify for the participant which distributions are taxable upon withdrawal and which are exempt from taxation.

- *Individual participant's account information*—For each employee who participates in the 401(k) plan, a separate participant statement that identifies the participant's share of the total net assets of the plan must be maintained. The plan instrument will describe how changes in the value of net assets are to be allocated to the participant's accounts. The individual participant account records must be reconciled with the plan sponsor's records to determine that the total of all individual participants' accounts equals the total of all allocated plan assets. Revenue Ruling 70-125 of the Internal Revenue Code requires that these totals be in agreement.
- *Administrative expenses*—Invoices, contracts, agreements, or other written evidence will normally be provided to verify these expenses. These expenses may include fees for the recordkeeper, trustee fees, attorney's fees (for example, to write a plan amendment), independent auditor fees (for example, performance of the audit), and so on.
- *Reconciliations*—The plan administrators ordinarily reconcile the company's records for the plan to data obtained from third-party administrators and the information provided by the trustee; plan administrators also investigate any discrepancies in the information provided.

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Reporting Standards

ERISA sets forth the requirements for annual reporting of employee benefit plans, including 401(k) plans. Annually, the sponsor must provide certain information to various federal governmental agencies including the DOL and the IRS. The DOL currently requires the following financial statements and supplemental schedules, if applicable:

- Statement of Net Assets Available for Benefits (comparative) and Statement of Changes in Net Assets Available for Benefits
- Schedule of Delinquent Participant Contributions; Schedule of Assets (Held at End-of-Year) and Schedule of Assets (Acquired and Disposed of Within Year)
- Schedule of Reportable Transactions; Schedule of Loans or Fixed-Income Obligations in Default or Classified as Uncollectible
- Schedule of Leases in Default or Classified as Uncollectible

NONEXEMPT TRANSACTIONS

For most plans, the information is currently reported on Form 5500, *Annual Return/ Report of Employee Benefit Plan*, which is filed with the Department of Labor. Form 5500 generally includes financial statements prepared in conformity with accounting principles generally accepted in the United States (GAAP). If the financial statements are not in compliance with GAAP in any significant way, that departure must be identified in the footnotes to the financial statements. ERISA also requires plans to furnish to each plan participant, at least annually, a statement of the participant's total vested and nonvested accrued benefits and a summary annual report (SAR). (See appendix A of the AICPA Audit and Accounting Guide *Employee Benefit Plans* for a further description of ERISA and related regulations.)

The previously mentioned Form 5500 filing and audit requirement is also required for 403(b) plans that have 100 or more participants.

Some 401(k) defined contribution plans are required to register and file a report with the SEC under the requirements of the Securities Exchange Act of 1933 (1933 Act). These requirements mandate registration, typically using Form S-8 for employer securities offered to the plan. This then requires the plan to file a Form 11-K under the Securities Exchange Act of 1934. The 1933 Act provides exemptions for registration requirements for plans that do not involve the purchase of employer securities with employee contributions. All other plans are subject to the 1933 Act provided they are both voluntary and contributory. You should consult with the plan's legal counsel to determine whether the plan is subject to such reporting requirements. For additional information, see the section *SEC Form 11-K Filing Requirements later* in this chapter. Instead of requiring plans to file under Regulations S-X, Article 6A, the SEC has amended its rules for Form 11-K to permit plans subject to ERISA to elect to file financial statements in accordance with ERISA guidelines.

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Governmental Regulations

The IRC has many provisions that affect employee benefit plans including 401(k) plans. If the plan qualifies under Section 401(a) of the IRC, certain tax benefits are available. These include (*a*) current tax deductions by plan sponsors for contributions, subject to certain limitations; (*b*) deferment of income to participants until the benefits are distributed; (*c*) exemption of the plan's trust from income taxes, other than tax on unrelated business income; and (*d*) favorable tax treatment of certain benefit distributions to participants or their estates.

Administrators of a 401(k) plan subject to ERISA must file an annual report for each plan every year. Under the "80-120 rule," if a plan has between 80 and 120 participants (inclusive) at the beginning of the plan year, the plan may elect to file a "small" or "large" plan Form 5500 for the plan year based on the annual return or report form that was filed for the previous year.

Plans with 100 or more participants at the beginning of the plan year that file Form 5500 are required to have an annual audit of their financial statements. Plans with fewer than 100 participants at the beginning of the plan year that filed as a small plan in the previous year are exempt from the audit requirement. Plans with fewer than 100 participants that do not meet certain DOL requirements regarding "qualifying plan assets" are not eligible for the small pension plan audit waiver and are required to have an annual audit of their financial statements. Also, plans with fewer than 100 participants that elect to file as a large plan under the 80-120 rule, rather than as a small plan filer in the previous year, are also required to engage an independent qualified public accountant to audit the plan.

(Note that these same requirements are in effect for 403(b) plans.)

KNOWLEDGE CHECK

2. The following 401(k) plan does not require an audit:

   a. A plan with 121 participants at the beginning of the plan year.
   b. A plan with 90 participants at the beginning of the plan year that files Form 5500 Schedule I.
   c. A plan with 80 participants at the beginning of the plan year that files Form 5500 Schedule H.
   d. A plan with 60 participants at the beginning of the plan year.

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Audit Requirements

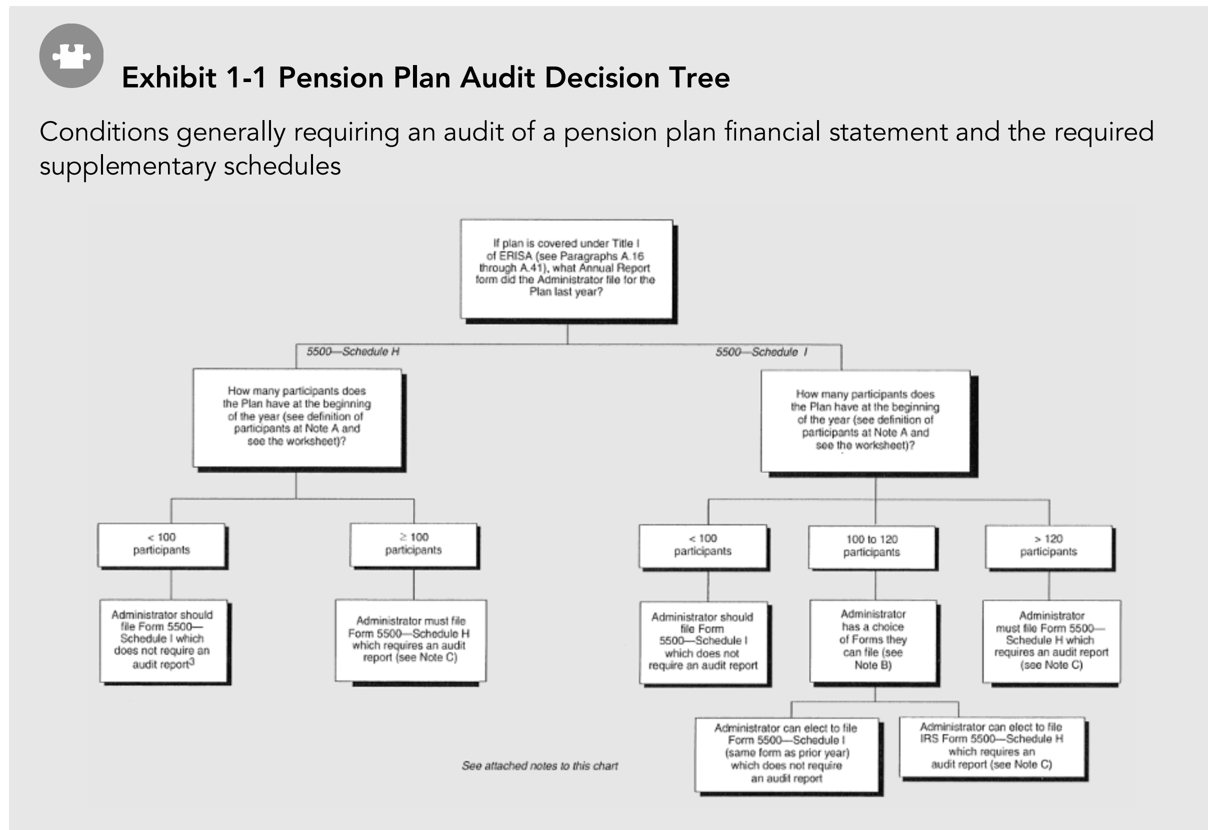
ERISA also requires an annual audit of plan financial statements by an independent qualified public accountant. Most plans with 100 or more participants in the plan at the beginning of the year satisfy this requirement. See previous discussion for more information on determining when an audit is required. The independent auditor's objectives and responsibility are established under generally accepted auditing standards (GAAS), which state that the auditor is to express an opinion on whether the financial statements are fairly presented in conformity with generally accepted accounting principles. The auditor also should state that the related supplemental information is presented fairly, in all material respects, when considered in conjunction with the financial statements taken as a whole. The opinion should identify the country of origin of the accounting principles that were used to prepare the financial statements. In addition, the auditing standards that you followed in performing the audit should be stated. The audit requirement is an important tool used by ERISA to protect plan participants. However, an audit performed under generally accepted auditing standards is not designed to make sure that all the requirements of ERISA, the DOL, and the IRS are satisfied. However, the annual report and the financial statements prepared by the plan administrator and the independent auditor's report assist these regulatory agencies in their monitoring and oversight functions. The audit is one of the important components of the financial information reported by the plan administrator, although the audit does not make sure compliance with all legislative and regulatory requirements.

As mentioned earlier, 403(b) plans with 100 or more participants as of the beginning of the plan year are also subject to the audit requirements stated earlier.

The decision tree in the following material reflects the previously mentioned requirement.

Exhibit 1-1 Pension Plan Audit Decision Tree

Conditions generally requiring an audit of a pension plan financial statement and the required supplementary schedules



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Note A—Participants are defined by the DOL as follows:

Active participants

- Any individuals who are currently in employment covered by a plan and who are earning or retaining credited service under a plan
- Any individuals who are currently below the integration level in a plan that is integrated with social security, or eligible to have the employer make payments to a 401(k) or section 125 arrangements. (Participants only have to be eligible for the plan, not necessarily participating in a 401(k) or Section 125 arrangement.)
- Any nonvested individuals who are earning or retaining credited service under a plan

The term *active participant* does not refer to nonvested former employees who have incurred the break-in-service period specified in the plan.

Inactive participants

Any individuals who are retired or separated from employment covered by a plan and who are receiving or entitled to receive benefits.

The term *inactive participant* does not refer to any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan.

Deceased participants include the following:

- Any deceased individuals who have beneficiaries who are receiving or are entitled to receive benefits under the plan

The term *deceased participant* does not refer to any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the beneficiaries of the individual are entitled under the plan.

Note B—*80–120 Rule* (Does not apply in the initial year of the plan)

Under 29 CFR 2520.103-1d, if a plan has between 80 and 120 participants (inclusive) as of the beginning of a plan year, it may elect to file the same category of form it filed in the prior year (for example, Form 5500, Schedule I "Financial Information—Small Plans") and avoid the audit requirement. This means that plans with between 80 and 120 participants at the beginning of the plan year that filed a Form 5500, Schedule I, "Financial Information—Small Plans," in the prior year may elect in the current year to complete Form 5500 following the requirements for a small plan. There is no limit to the number of years this election can be made. DOL officials have indicated that health and welfare plans with 100 or more participants that involve employee contributions generally are required to have an audit unless employee contributions are used to purchase insurance from a third-party insurer or forwarded to a health maintenance organization within prescribed timeframes, even if the plan sponsor does not maintain a trust and considers the assets to be subject to the rights of general creditors (29 CFR 2520.104-44). In these circumstances, careful consideration is given as to whether an audit is required.

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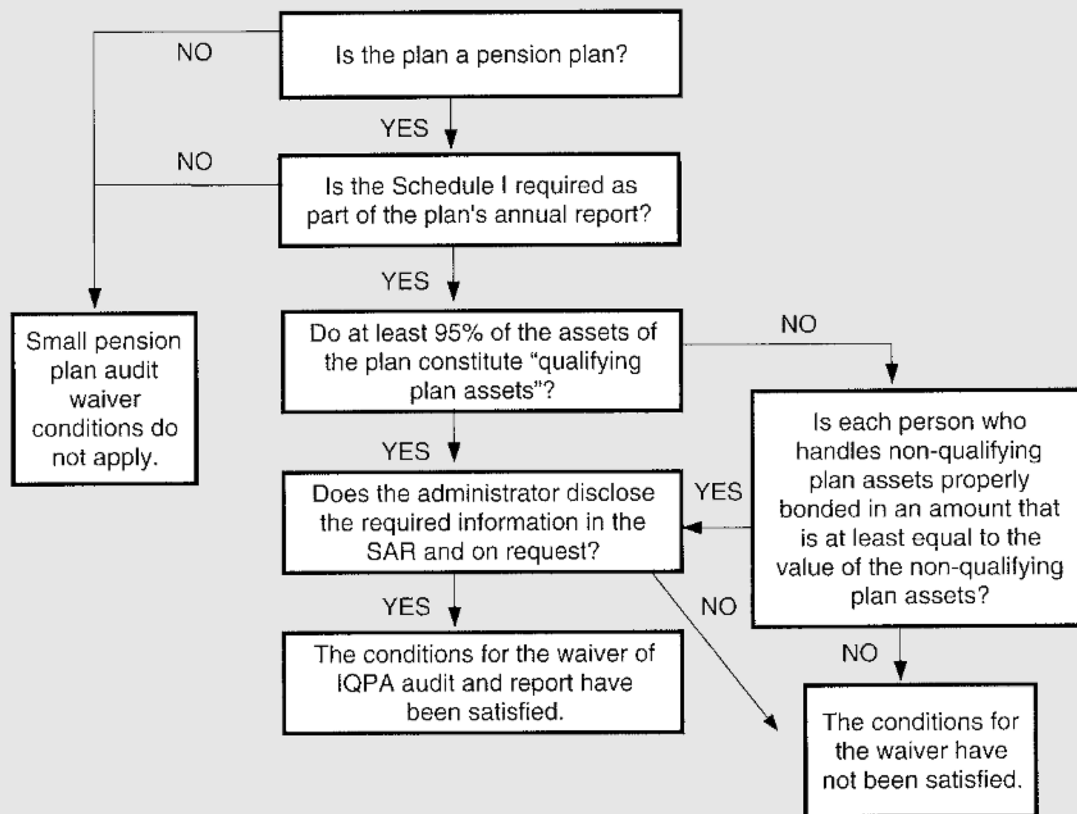
Note C—*Audit Requirement*

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

Exhibit 1-2 Small Pension Plan Audit Waiver (SPPAW) Summary



In determining whether a 401(k) plan has 100 "participants," each employee who is eligible to make a contribution, (that is, has satisfied the eligibility requirements of the plan such as age and service), is counted as a participant regardless of whether or not that employee elects to contribute or has an account under the plan.

The plan administrator must file the annual report by the last day of the seventh month after the end of the plan year, including a short plan year (any plan year less than 12 months). For a plan that is terminating, the plan's final Form 5500 is due within seven months following the date the plan's assets were completely distributed. A one-time extension of time up to two and one-half months may be granted for filing the annual report if Form 5558, *Application for Extension of Time to File Certain Employee*

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Plan Returns, is filed with the IRS before the normal due date of the report. The plan administrator must file a copy of the extension with the annual report. In addition, if the plan sponsor's corporate tax return has been extended, then the plan will automatically receive an extension for one and one-half months. Again, a copy of the extension must be filed with the annual report.

KNOWLEDGE CHECK

3. The plan sponsor has the following active employees at the beginning of the plan year:

Vested employees	77
Nonvested employees earning service	12
Nonvested employees not eligible because of the plan's age and service requirements	14
Nonvested employees eligible for the plan electing not to participate	22

What is the total number of participants at the beginning of the plan year?

a. 77.
b. 89.
c. 103.
d. 111.
e. 125.

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Reporting and Disclosure Requirements Under ERISA

ERISA imposes various rules regarding the operation and reporting practices for employee benefit plans. It establishes minimum standards of vesting for defined contribution plans sponsored by private entities in addition to establishing extensive reporting requirements as described previously. ERISA gives the IRS and DOL authority to issue reporting and disclosure requirements and certain administrative responsibilities.

ERISA also sets standards of fiduciary conduct and imposes specific restrictions and responsibilities on fiduciaries. These responsibilities include managing and operating the plan in the best interests of the plan participants. The fiduciary is prohibited from permitting the plan to engage in prohibited (nonexempt) party in interest transactions. (See chapter 3, “Internal Control Structure,” and chapter 6, “Other Auditing Considerations.”)

In addition, ERISA gives the DOL authority to reject reports of plans that do not meet the reporting and disclosure requirements. Working papers that support audits of employee benefit plans must be maintained for a period of six years. Section 502(c)(5) of ERISA describes penalties that the DOL can assess up to $1,000 a day for failure or refusal to file a report.

FASB ASC 962, *Plan Accounting—Defined Contribution Pension Plans*, addresses the accounting and reporting specifically for defined contribution pension plans. Accounting principles generally accepted in the United States of America are also effectively established through the AICPA Audit and Accounting Guide *Employee Benefit Plans*. In addition, FASB ASC 815, *Derivatives and Hedging*, and FASB ASC 820, *Fair Value Measurement*, have been reflected throughout this course where applicable.

KNOWLEDGE CHECK

4. Working papers that support audits of employee benefit plans that do not file form 11-K with the SEC must be maintained for a period of

    a. Five years.
    b. Six years.
    c. Seven years.
    d. Indefinitely.

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SEC Form 11-K Filing Requirements

As noted previously, certain plans and related entities may be subject to the requirements of the Securities and Exchange Act of 1933 (1933 Act). These requirements mandate registration, usually on Form S-8 for plan securities, and require annual reporting on Form 11-K under the Securities and Exchange Act of 1934 (1934 Act). Section 3(a)(2) of the 1933 Act permits an exemption from this reporting requirement for defined contribution plans that do not offer, as an investment option, the purchase of employer securities with employee contributions. All other 401(k) plans that offer an employer stock investment option to participants on a voluntary and contributory basis are subject to the 1933 Act. The plan administration should consult with legal counsel to determine if an 11-K filing is required for the plan.

For a plan to be both voluntary and contributory, the employees must be given the option to contribute their own funds to the plan and, in doing so, the participants must know that these contributions could be used, at any point, to acquire employer securities.

As an option, the 1934 Act permits plans subject to ERISA filings to elect to file plan financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA rather than follow the requirements of the 1934 Act as contained in Article 6A of Regulation S-X. Plans subject to the SEC Form 11-K filing requirements generally must be audited by an independent public accountant. However, the SEC will not accept an ERISA limited-scope audit report filed in connection with an 11-K filing even if the plan has elected to file its financial statements in accordance with the financial reporting requirements of ERISA, rather than Article 6A of Regulation S-X. Plans that file reports on Form 11-K in connection with the 1934 Act must do so within 90 days after the end of the plan's fiscal year. A plan that files under the ERISA guidelines must file the Form 11-K within 180 days after the plan's fiscal year-end. See chapter 7, "The Auditor's Report and Financial Statement Disclosures," for additional. information.

Note that many of the provisions of the Sarbanes-Oxley Act of 2002 apply to the audits of employee benefit plans that file on Form 11-K. Audit reports issued for public entities subject to the requirements under Sarbanes-Oxley Act of 2002 must reference the standards issued by the PCAOB. These standards have been adopted by the PCAOB and approved by the Securities and Exchange Commission:

- AS 1215: *Audit Documentation*
- AS 6115: *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
- AS 2201: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
- AS 2820: *Evaluating Consistency of Financial Statements*
- AS 1220: *Engagement Quality Review*
- AS 1101: *Audit Risk*
- AS 2101: *Audit Planning*
- AS 1201: *Supervision of the Audit Engagement*
- AS 2105: *Consideration of Materiality in Planning and Performing an Audit*
- AS 2110: *Identifying and Assessing Risks of Material Misstatement*
- AS 2301: *The Auditor's Responses to the Risks of Material Misstatement*
- AS 2810: *Evaluating Audit Results*
- AS 1105: *Audit Evidence*
- AS 1301: *Communications with Audit Committees*
- AS 2701: *Auditing Supplemental Information Accompanying Audited Financial Statements*
- AS 2410: *Related Parties*

See chapter 6, "Other Auditing Considerations," for additional information.

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ERISA Limited-Scope Audits

As permitted by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA, the plan administrator is permitted to instruct you not to perform any auditing procedures with respect to information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency and that acts as trustee or custodian for the plan's assets. The ERISA limited-scope audit is available, however, only if the trustee or custodian certifies both as to accuracy and completeness of the information submitted. Certifications that address only accuracy or completeness, but not both, do not comply with the DOL's regulations, and, therefore, are not adequate to allow plan administrators to limit the scope of the audit.

This ERISA limited-scope audit provision does not apply to information regarding investments held by a broker-dealer or some investment companies, that is, those that are not chartered and regulated by a federal or state agency. The ERISA limited-scope audit applies only to a bank, an insurance carrier, or a similar institution that is federally or state chartered and is regulated, supervised, and subject to periodic examination by a state or federal agency. The ERISA limited-scope audit applies only to investment information (including investments, investment income, and related expenses, as well as notes receivable from participants), and does not extend to withdrawals, contributions, or other information, whether or not it is certified by the trustee or custodian. Note that whereas notes receivable from participants are not characterized as "investments" for financial statement reporting purposes, loans by participants are treated as a receivable of the plan (see chapter 4 for further information). Notes receivable from participants are reported on Form 5500 as investments, and if held and certified by the trustee, would not be subject to audit.

Thus, except for the investment-related activity certified by the trustee or custodian (or both), an auditor conducting an ERISA limited-scope audit would need to include in the scope of the audit all other functions performed by the plan sponsor or other third-party service organizations. The nature and scope of testing will depend on a variety of factors, including the nature of the functions being performed by the third-party service organization and whether a SOC 1® report that addresses areas other than investments is available, if deemed necessary. If a SOC 1® report is available, the nature and scope of testing will depend on the type of SOC 1® report and the related results. (See chapter 3 for further information on SOC 1® reports.) The ERISA limited-scope audit does not relieve the plan from the requirement to have an audit.

AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of an entity that uses one or more service organizations.

AT-C section 320, *Reporting on an 'Examination of Controls at a Services Organisation Relevant to User 'Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*), contains performance and reporting requirements and application guidance for a service auditor examining controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. The AICPA Guide *Reporting on an Examination of Controls at a Service Organisation Relevant to User Entities' Internal Control Over Financial Reporting (SOC 1®)* contains guidance to assist service auditors in performing and reporting on these engagements.

Plan investments not held by a qualifying institution should be subjected to appropriate audit procedures. Plans may hold investment assets, only a portion of which is covered by a certification by a qualifying institution. In that case, the balance of the investments is not eligible for the ERISA limited-scope audit and should be subjected to auditing procedures by the plan auditor. In these circumstances, the ERISA

limited-scope audit report would be required if the plan's assets that are not audited (that is, those assets covered by the trustee's or custodian's certification) are material to the plan's financial statements taken as a whole. See chapter 7 for a sample of the auditor's report in this situation.

When you are engaged to perform an ERISA limited-scope audit and consequently disclaims an opinion on the financial statements as a whole, you are not permitted to issue an opinion on the supplemental schedules. However, because the DOL requires supplemental schedules to be presented with the financial statements, you are required to follow the guidance in AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*). See chapter 7 for further discussion when reporting on supplemental schedules when performing an ERISA limited-scope audit.

KNOWLEDGE CHECK

5. Which of the following is an example of a certification that would be acceptable for an ERISA limited-scope audit?

    a. ABC Bank certifies the attached statements are complete and accurate.
    b. XYZ Insurance Company certifies the attached information is accurate.
    c. DEF Recordkeeper certifies that the attached information is complete and accurate.
    d. RST Brokerage Company certifies that they hold the following investments and the information is complete and accurate.

6. The 401(k) plan for ABC Corp. holds investments in two separate institutions. One is a regulated bank (holds 95 percent of the investments); the other is a broker-dealer (holds the remaining 5 percent of the investments). Provided all other requirements regarding limited-scope are met, the auditors may limit their testing of investments

    a. Only for the investments held by the bank.
    b. Only for the investments held by the broker-dealer.
    c. On all investments held by both the bank and the investment company.
    d. On none of the investments because some of the investments are held by a company that does not qualify for the ERISA limited-scope audit.

7. What type of audit report should be issued for ABC Corp. in question 6, assuming no errors or irregularities were noted during the audit?

    a. Unqualified audit report.
    b. ERISA limited-scope audit report.
    c. Disclaimer due to omitted information.
    d. Adverse opinion because a majority of the investment information was not audited.

8. An ERISA limited-scope audit under the DOL regulations limits the scope in relation to

    a. Investment allocation testing for participant accounts.
    b. Contributions.
    c. Expenses.
    d. Investments and investment activity.

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