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Employee Benefit Plan Audits
Time to Implement SAS 136 (AU-C 703)

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Auditors will be following Statement on Auditing Standards (SAS) 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, to perform and report on employee benefit plan (EBP) financial statement audits. SAS 136, as amended, is codified in AU-C 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, and is effective for audits of financial statements for periods ending on or after December 15, 2021. Early adoption was permitted but surveys indicate that only about 10% of firms did early adopt. SAS 136 includes new requirements in all phases of an audit of Employee Retirement Income Security Act of 1974 (ERISA) plan financial statements, including engagement acceptance, risk assessment and response, communication with those charged with governance, performance procedures, and reporting. The extent of change for a practitioner will depend on how consistent their prior procedures were with the changes in AU-C 703. However, at a minimum, all practitioners will need to revise audit opinions, engagement letters, representation letters, and governance communication letters.

SAS 136 particularly impacts limited scope audits. SAS 136 now refers to such audits as an "ERISA section 103(a)(3)(C) audit." ERISA section 103(a)(3)(C) permits plan management to elect to exclude from the audit certain investment information a qualified institution holds and certifies. These were referred to as a "limited-scope audit." SAS 136 does not and cannot change anything in ERISA and, therefore, plan management's ability to elect such an audit continues. SAS 136 clarifies what is expected of the auditor, including specific procedures when performing an ERISA section 103(a)(3)(C) audit, and establishes a new form of report.

Practice Note: When plan management elects to have an ERISA section 103(a)(3)(C) audit, the scope of the audit is no longer considered limited even though the auditor will not audit certified investment information. The auditor no longer issues a modified opinion

(typically a disclaimer of opinion) due to only performing limited procedures on information that is certified by a qualified institution. Instead, the auditor report provides a two-pronged opinion that is based on the audit and on the procedures performed relating to the certified investment information. It provides an opinion on whether the information not covered by certification is presented fairly, and an opinion on whether the certified investment information in the financial statements agrees to or is derived from the certification. However, if the auditor identifies a material misstatement of the financial statements or there is a limitation on the scope of the audit (for example, lack of books and records), then the auditor would modify the opinion in accordance with AU-C 703 and AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*.

In this report, we discuss the major changes introduced by SAS 136. SAS 136 requires the auditor to perform certain procedures when planning and performing the audit that, in the past, were not expressly required.

Overview

SAS 136 creates a new AU-C 703 in AICPA Professional Standards, which becomes the foundational AU-C section that addresses the auditor's responsibility to form an opinion on the ERISA plan financial statements and prescribes the form and content of the auditor's report for ERISA plan audits. AU-C 703 applies to audits of single employer, multiple employer, and multiemployer plans subject to ERISA. AU-C 703 should not be adapted for plans that are not subject to ERISA (such as a church plan). AU-C 703 is not all-inclusive; when performing an EBP audit, all the AU-C sections apply except for the following, which are specifically covered in AU-C 703:

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

In addition, AU-C 703 contains incremental requirements to AU-C 210, *Terms of Engagement*; AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*; AU-C 260, *The Auditor's Communication With Those Charged With Governance*; and AU-C 580, *Written Representations*.

Practice Note: AU-C 703 replaces AU-C 700 in its entirety when performing an audit of ERISA plan financial statements. AU-C 705 and 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, address how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an emphasis-of-matter or other-matter paragraph in the auditor's report. Auditors should comply with AU-C 705 and 706 when performing ERISA audits; however, AU-C 703 provides the auditor with specific guidance on when and how to apply AU-C 705 when performing an ERISA section 103(a)(3)(C) audit.

Engagement Acceptance

In addition to the preconditions for an audit in AU-C 210, AU-C 703 includes new engagement acceptance requirements. It requires that the auditor obtain the agreement of management that it acknowledges and understands its responsibilities for the following (which can be done through the engagement letter):

- Maintaining a current plan instrument, including all plan amendments (***CPEA Observation***: Regulators often find that current plan instruments are not maintained in auditor files or management files and also have stressed the importance of having an executed plan instrument)
- Administering the plan and determining the plan's transactions that are presented and disclosed in the 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
- When management elects to have an ERISA Section 103(a)(3)(C) audit, determining whether
    - An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances
    - The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8
    - The certification meets the requirements in 29 CFR 2520.103-5
    - The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework

As part of engagement acceptance when management elects to have an ERISA Section 103(a)(3)(C) audit, the auditor is required to inquire of management about how management determined that the entity preparing and certifying the investment information is a qualified institution under DOL rules and regulations (note that investment companies and broker-dealers are not considered qualified institutions as it relates to providing a certification; however, some of these institutions have established separate trust companies which could meet the requirements of a qualified institution).

Practice Note: Related to some clients, management may have relied on service providers or even the auditor to determine or obtain these items. In those cases, these requirements may pose a burden to management. The AICPA's EBP Audit Quality Center developed a tool to assist management in assessing whether the conditions for electing an ERISA Section 103(a)(3)(C) audit have been met. The tool is intended to be completed by management for the auditor's use in evaluating management's assessment

as required by AU-C 703. Auditors may find it effective to review the certification with the client, going over a series of questions and documenting the details of the discussion.

The auditor also should obtain the agreement of management or those charged with governance to provide to the auditor, prior to the dating of the auditor's report, a draft of Form 5500 that is substantially complete. Paragraph 2.47 of the AICPA Audit and Accounting Guide, *Employee Benefit Plans* (the EBP Guide), defines a draft of Form 5500 that substantially is complete as one that includes the forms and schedules that could have a material effect, involving both qualitative and quantitative considerations, on the information in the financial statements and ERISA-required supplemental schedules. See the section "Considerations Relating to The Form 5500" in chapter 13 of the EBP Guide for a discussion about the auditor's responsibilities relating to Form 5500 in an ERISA plan audit and for determining whether a draft Form 5500 is substantially complete. See the "Reading the Draft Form 5500" section later in this report for further requirements related to the draft Form 5500.

Practice Note: Obtaining a draft Form 5500 that is substantially complete may represent a substantial change for some auditors and management depending on the Form 5500 preparer. Anecdotal reports have indicated that the magnitude of the change is largely predicated on the prior processes of the Form 5500 preparers. If the Form 5500 was not historically available prior to the release of the audit report, practitioners should discuss with management the need to obtain a substantially complete Form 5500 in the planning process.

<u>Risk Assessment</u>

AU-C 703 requires that the auditor:

- 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

  Practice Note: Many of the financial statement amounts in ERISA plan financial statements are determined from provisions specified in the plan instrument. Examples of plan provisions include types of contributions and distributions, timing of the contributions, vesting and forfeitures, participant loans, and transfers. When considering whether to test specific plan provisions as part of risk assessment, because of the nature of ERISA audits, 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. Appendix A to AU-C 703 provides some examples of plan provisions often included in a plan instrument by audit area.

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 (AU-C 703.26).

Practice Note: Many auditors may be currently testing relevant plan provisions and, as such, these risk assessment related requirements may not represent a substantial change. However, some early adopters have noted that risk assessment documentation needed to be revised as some firms were not explicitly documenting identified risks and responses related to relevant plan provisions.

EBP Tax Status

AU-C 703 clarifies that the EBP's tax status is fundamental and requires the auditor to consider whether management has performed the relevant IRC compliance tests, including but not limited to, discrimination testing, and has corrected or intends to correct failures, as applicable, in accordance with AU-C 250 requirements. Many auditors may currently be doing this. It also should be noted that the EBP Guide at 9.27e indicates that failure to correctly perform nondiscrimination tests is an example of an identified risk at the assertion level regarding the plan's tax status. However, regarding a potential response to an identified risk at the assertion level, the EBP Guide also notes that "auditors are not expected to test the underlying calculations for the tests…but, rather, are expected to inquire if the testing was performed in accordance with the respective requirements using the appropriate data."

Prohibited Transactions

AU-C 703 requires auditors to evaluate whether prohibited transactions identified by management or as part of the audit have been appropriately reported in the applicable ERISA-required supplemental schedules.

If the auditor becomes aware that the EBP has entered into a prohibited transaction with a party in interest, and the prohibited transaction has not been properly reported in the applicable ERISA-required supplemental schedule, the auditor should discuss the matter with management. If management does not revise the ERISA-required supplemental schedule, the auditor should discuss the matter with those charged with governance (unless all those charged with governance are involved in managing the EBP). If the ERISA-required supplemental schedule is not revised, the auditor should modify the auditor's opinion on the ERISA-required supplemental schedule, when the effect of the transaction is material based on the financial statements as a whole. When the effect of the prohibited transaction is not material to the financial statements, then the auditor

should include additional discussion in the other-matter paragraph in the auditor's report on the ERISA-required supplemental schedules describing the prohibited transaction.

If a material prohibited party-in-interest transaction that is not disclosed in the ERISA-required supplemental schedule also is considered a related party transaction and that transaction is not properly disclosed in the notes to the ERISA plan financial statements, the auditor should modify the auditor's opinion on the financial statements in accordance with AU-C 705 due to a departure from the applicable financial reporting framework.

Evaluation and Reportable Findings

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:

- An identified instance of noncompliance or suspected noncompliance with laws or regulations in accordance with AU-C 250
- 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
- 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

On a timely basis, the auditor should communicate in writing to those charged with governance, reportable findings. 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 description of the reportable finding
- Sufficient information to enable those charged with governance and management to understand the context of the communication
- 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 indicating that no reportable findings were identified during the audit. The auditor remains required to communicate significant deficiencies and material weaknesses. It is possible that reportable findings

may overlap with significant deficiencies and/or material weaknesses. As a result, some firms have decided to issue a combined governance communication which incorporates reportable findings as well as any significant deficiencies and/or material weaknesses.

Practice Note: The requirement to communicate reportable findings is a substantial change introduced by AU-C 703. We think it would be prudent to discuss these changes in advance with plan audit clients. Some early adopters report having reportable findings in substantially all plan audits, this may surprise some plan audit clients particularly those who are sensitive to content in governance letters. The auditor may want to discuss reportable findings with management prior to the written communication so that the plan administrator can take corrective action in a timely manner. Reportable findings should not be included in the engagement letter or be attached to the Form 5500.

Procedures for an ERISA Section 103(a)(3)(C) Audit

When management elects to have an ERISA Section 103(a)(3)(C) audit (formerly referred to as a limited scope audit), the auditor should evaluate management's assessment of whether the entity issuing the certification is a qualified institution under Department of Labor (DOL) rules and regulations. If the institution is not qualified, the auditor is precluded from performing the ERISA Section 103(a)(3)(C) audit.

Practice Note: The nature of procedures necessary to evaluate management's assessment may vary depending upon the auditor's knowledge of the plan and types of investments held. In some instances, inquiry of management may be sufficient.

If the auditor has concerns about whether the entity preparing and certifying the investment information is a qualified institution, the auditor should discuss these 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 these concerns with those charged with governance and determine the implications for the audit.

The auditor should identify which investment information is certified and 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
- 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

Practice Note: It should not be assumed that qualifying institutions will certify investment information in accordance with U.S. GAAP. Some qualifying institutions will certify investment information on a cash, modified accrual basis of accounting, or other basis of accounting.

If the auditor becomes aware that the certified investment information in the financial statements and related disclosures is incomplete, inaccurate, or otherwise unsatisfactory, the auditor should discuss the matter with management and perform additional procedures to determine the appropriate course of action.

The auditor should perform audit procedures on the financial statement information, including the disclosures, not covered by the certification as well as noninvestment-related information based on the assessed risk of material misstatement. Plans may hold investments in which only a portion are covered by a certification by a qualified institution (for example, a certification may not cover investments that do not have a readily determinable fair value). In that case, the auditor should perform audit procedures on the investment information that has not been certified.

For all audits of ERISA plan financial statements, including an ERISA Section 103(a)(3)(C) audit, the auditor should perform the procedures necessary to become satisfied that received and disbursed amounts (for example, employer or employee contributions and benefit payments) reported by the trustee or custodian were determined in accordance with the plan provisions.

<u>Written Representations</u>

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:

- That management has provided the auditor with the most current plan instrument for the audit period, including all plan amendments
- 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
- When management elects to have an ERISA Section 103(a)(3)(C) audit, acknowledgement that management's election of the ERISA Section 103(a)(3)(C) audit does not affect its responsibility for the financial statements and for determining whether
    - An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances

    - The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8
    - The certification meets the requirements in 29 CFR 2520.103-5
    - The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework

<u>Auditor Report Changes</u>

AU-C 703 significantly changes the form and content of the auditor's report, as indicated below.

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

- The first section of the auditor's report should include a description of the scope and nature of the ERISA Section 103(a)(3)(C) audit and should have the heading "Scope and Nature of the ERISA Section 103(a)(3)(C) Audit."
- The auditor will no longer issue a disclaimer of opinion. The "Opinion" section is required to directly follow the "Scope and Nature of the ERISA Section 103(a)(3)(C) audit" section and provides a two-pronged opinion addressing whether:
    - The amounts and disclosures in the ERISA plan financial statements that are not covered by the certification are presented fairly in accordance with the applicable financial reporting framework
    - The investment information in the ERISA plan financial statements related to the certified investment information agrees to or is derived from the certified investment information provided by a qualified institution
- The auditor's opinion should identify the applicable financial reporting framework and its origin
- The "Basis for Opinion" section is required to follow the opinion section, including a statement that the auditor is required to be independent of the entity and to meet the auditor's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit
- Enhanced auditor reporting relating to going concern is added, including a description of the respective responsibilities of management when required by the applicable financial reporting framework, and the auditor for going concern
- An expanded description of management's responsibilities is added, including management's responsibilities 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

- An expanded description of the auditor's responsibilities section is added, including the auditor's responsibilities relating to professional judgment and professional skepticism, and the auditor's communications with those charged with governance -- The description should indicate that:
    - The 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 the applicable financial reporting framework
    - Accordingly, the objective of the ERISA Section 103(a)(3)(C) audit is not to express an opinion about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with the applicable financial reporting framework

Non-section 103(a)(3)(C) audits

Non-section 103(a)(3)(C) audits (formerly known as "full-scope reports") contain elements similar to those required for audits subject to the requirements of SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, (substantially codified in AU-C 700). However the following exceptions exist:

- The opinion section identifies the plan as an employee benefit plan subject to ERISA
- Expanded description of management's responsibilities as described previously for the ERISA section 103(a)(3)(C) report
- Includes new content in the other-matter paragraph relating to the ERISA-required supplemental schedules, including a new form and content opinion on the supplemental schedules

Other Details

AU-C 703 also requires the use of specific headings (e.g., "Opinion," "Basis for Opinion," etc.). AU-C section 703 includes illustrative auditor's reports. In addition, it includes reporting guidance for the auditor's report for audits:

- Conducted in accordance with both GAAS and another set of auditing standards
- Where prior period financial statements were audited by a predecessor auditor
- Where prior period financial statements were not audited

Report on ERISA-Required Supplemental Schedules

For an audit not subject to ERISA Section 103(a)(3)(C), AU-C 703 requires the auditor to report on whether the ERISA-required supplemental schedules are fairly stated, in all material respects, in relation to the financial statements as a whole. AU-C section 703 also requires the auditor, in situations in which the auditor's report on the audited financial statements contains an unmodified or a qualified opinion, to include a statement about whether, in the auditor's opinion, the form and content of the information in the accompanying schedules are presented in conformity with the DOL's Rules and Regulations for Reporting and Disclosure under ERISA.

Auditor's Reports for Initial Year of Implementation of AU-C 703 & Illustrations

When SAS 136 was issued, Illustration B-1 in AU-C 703 presented a comparative example report for the initial year of implementation of AU-C 703 (with a prior period under previous reporting standards). Specifically, Illustration B-1 in AU-C 703 presents – *The Auditor's Reports on Financial Statements for a Defined Contribution Retirement Plan Subject to ERISA When Management Elects an ERISA Section 103(a)(3)(C) Audit in the Current Year (2020) and the Auditor Disclaimed an Opinion on the Financial Statements in the Prior Year (2019).* In the illustration, the auditor is issuing two separate reports: (1) an opinion on the current year financial statements where the auditor performed an ERISA Section 103(a)(3)(C) audit and followed the new report form in AU-C 703; and (2) a disclaimer of opinion on the prior year using the pre-AU-C 703 report form.

Subsequently, after SAS 141, *Amendment to the Effective Dates of SAS Nos. 134-140,* permitted early adoption of AU-C 703 and in response to questions, the AICPA staff developed nonauthoritative guidance to help auditors apply AU-C 703 in the initial year of implementation with more flexible reporting options. The guidance is titled *Employee Benefit Plans Industry FAQ with Illustrative Auditor's Reports for Initial Year of Implementation of SAS No. 136, as Amended*, and can be accessed here. The guidance provides many illustrations of options for reporting in the year of implementation of AU-C 703 under various scenarios including showing the prior year DOL limited scope disclaimer as an "other matter" paragraph. Each illustration includes additional circumstances that are unique to that illustration.

Reading the Draft Form 5500

The auditor should make appropriate arrangements with management to obtain the draft Form 5500. The auditor should obtain and read the draft Form 5500 prior to dating the

auditor's report. The auditor should read the draft Form 5500 to identify material inconsistencies, if any, with the audited ERISA plan financial statements. The auditor should communicate with those charged with governance the auditor's responsibility with respect to Form 5500, procedures performed relating to Form 5500, and the results of those procedures.

If, after reading the draft Form 5500, the auditor identifies a material inconsistency, the auditor should determine whether the audited ERISA plan financial statements or the draft Form 5500 needs to be revised. If during the review of the Form 5500, the auditor becomes aware of a material misstatement of fact, the auditor is required to discuss it with management and, depending on management's response, take appropriate action as required by AU-C section 703. See paragraphs 50-59 of AU-C 703 for further details.