TESTIMONY OF

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BEFORE THE ERISA ADVISORY COUNCIL

Beyond Plan Audit Compliance: Improving the Financial Statement Audit Process

June 25, 2019

I am pleased to appear before the Advisory Council on behalf of the Employee Benefit Plan Audit Quality Center (EBPAQC) of the American Institute of Certified Public Accountants (AICPA) for which I serve as the Chair of the EBPAQC Executive Committee. The EBPAQC is a firm-based voluntary membership center with approximately 2,550 CPA member firms that audit employee benefit plans.

We commend the Advisory Council for holding this hearing to identify what actions the Secretary of Labor may take with respect to increasing the knowledge and understanding of the plan administrator that procures financial statement audit services and on improving the procedures that such plan administrators implement in selecting an auditor; preparing for the audit; communicating with the auditor before, during, and after the audit; and adopting changes in the plan's documentation, operations, policies, or procedures based on the results of the audit.

The AICPA provided materials to the Advisory Council in advance of today's hearing, which are included as Appendix A to this testimony. Those materials include copies of EBPAQC plan advisories developed for plan sponsors, administrators, and trustees to assist them in understanding their fiduciary and other responsibilities with respect to the plan audit and plan operations. These advisories discuss, among other matters, the following:

- the purpose, objectives and benefits of the independent audit
- the plan financial reporting and audit processes
- the auditor's responsibility for testing compliance with the Employee Retirement Income and Security Act (ERISA), Department of Labor (DOL) and Internal Revenue Service (IRS) requirements, and fraud detection
- the importance of hiring a quality auditor and information to help select a quality auditor
- various communications that may be initiated by the plan auditor, including certain communications to "those charged with governance," such as significant findings and issues from the audit, management letter comments, and communications about internal control related matters
- an understanding of "limited scope" audits of employee benefit plans under ERISA section 103(a)(3)(C), including the plan administrator's responsibilities for determining the acceptability of a limited scope certification, qualified institutions, and proper certifications
- how the plan audit can help improve the effectiveness of the plan's system of internal control

- the benefits of establishing an effective monitoring program over service organizations that perform recordkeeping and reporting functions for an employee benefit plan
- an understanding of the importance of properly maintaining and protecting plan records
- the plan administrator's responsibilities for valuing and reporting plan investments, and how the auditor can assist.

We recognize and applaud the Employee Benefits Security Administration (EBSA) efforts, through its Fiduciary Education Campaign, to provide compliance assistance by educating employers and service providers about their fiduciary responsibilities under ERISA. EBSA's program, "Getting It Right−Know Your Fiduciary Responsibilities," provides employers and plan officials with an understanding of the law and their responsibilities and focuses on steps for avoiding the most common problems EBSA encounters in its enforcement activities. EBSA also has published information relating to the financial reporting and audit process including *Reporting and Disclosure Guide for Employee Benefit Plans,* and *Selecting an Auditor for Your Employee Benefit Plan.* These resources are very helpful and serve to supplement the advice that plan administrators may receive from the plan service provider community. In EBSA's publication, *Selecting an Auditor for Your Employee Benefit Plan (September 2018),* EBSA observed:

> "A well performed audit is a vital protection for [an] employee benefit plan. It is in [the plan administrator's] best interest and that of the plan's participants to maximize the value of the audit process." … "A good quality audit will help protect the assets and the financial integrity of your employee benefit plan and provide the plan administrator with information to help ensure that the necessary funds will be available to pay retirement, health, and other promised benefits. One aspect of an audit is to evaluate the strength of the plan's internal controls over financial reporting, identifying control weaknesses or plan operational errors. This may help plan management improve and streamline plan operations. A quality audit also will help you as the plan administrator carry out your legal responsibility to file a complete and accurate Form 5500 annual return/report for your plan. Also, as the plan's administrator, you might be assessed a civil penalty for an incomplete, inadequate, or untimely audit report. Selecting an experienced, competent, and reliable auditor can help you avoid that."

We agree with EBSA and my remarks today will focus on how the plan administrator can maximize the value of the plan's financial statement audit. Much of my testimony will focus on the typical defined contribution 401(k) plan audit environment but I will also address certain unique aspects of defined benefit, health and welfare, and other plan types.

<u>The Plan Administrator's Fiduciary Responsibilities</u>

While the primary objective of the auditor is to express an opinion on whether the plan's financial statements are fairly presented, the audit process can also help the plan administrator keep apprised of matters that may need to be addressed to fulfill their responsibilities. The audit process provides an opportunity and discipline for the plan administrator to demonstrate due diligence by reviewing and enhancing matters relating to plan governance, operations, records, internal control, compliance, and reporting. The plan administrator's fiduciary responsibilities include plan administration functions such as maintaining the financial books and records of the plan, and to file a complete and accurate annual return/report for the plan on a timely basis. The auditor can provide feedback on the effectiveness of and suggestions for improving processes and controls in place related these fiduciary responsibilities and efficient and effective plan operations.

Plan governance

Fiduciaries can demonstrate that they have properly carried out their responsibilities related to plan governance by documenting the processes used to discharge those fiduciary responsibilities. For example, they should prepare and approve minutes of plan oversight meetings, including board of directors/audit committee, plan administrative/benefits committee, and investment committee meetings. In addition, fiduciaries should adequately document plan changes and policies, and ensure they have been properly approved, adopted, and implemented. To gain an understanding of the plan and its environment and assess audit risk, the plan auditor generally reviews this documentation. Discussions with the plan auditor about the review of this documentation can provide the plan administrator with valuable information about potential deficiencies and risks in the oversight process.

Plan operations

Following the terms of the plan document is also an important fiduciary responsibility. The plan document serves as the foundation for plan operations. While the plan auditor does not audit the plan document per se, the auditor does check that certain key information specified in the plan document is used to determine eligibility, contributions, vesting, participant allocations, distribution of benefits, and plan expenses. If the auditor identifies any instances where the plan is not operating in accordance with the plan document, that information should be communicated to the appropriate parties. The plan auditor also will check to see that those operational errors identified have been corrected.

Financial books and records and reporting

As part of their fiduciary responsibilities, it is important that plan administrators retain and maintain documents to support all plan activities, safeguard participant information, and comply with legal requirements (ERISA, DOL, and IRS), including IRS and DOL audits and examinations and financial statement audits. One important responsibility is maintaining the financial books and records of the plan. This includes ensuring contracts, policies and agreements, and other relevant documents are up-to-date and any amendments are approved and adopted; plan records are properly maintained and they are current, complete and accurate; and the sum of individual participant accounts from the recordkeeper are reconciled to trustee/custodian's trust statements. The audit process can help the plan administrator address all of these areas.

Internal control

Implementing effective internal control over financial reporting and monitoring outsourced recordkeeping and reporting functions establishes safeguards for plans to ensure plan administrators can adequately meet their fiduciary responsibilities. In addition, because errors and fraud can and do occur, it is important that the plan administrator establish safeguards to prevent or detect such errors and fraud, which can be accomplished by implementing effective internal control over financial reporting. The auditor is required to obtain an understanding of the plan and its environment, including the plan's internal control. As such, the auditor may identify areas where enhancements should be made to control policies and procedures. For example, the auditor may suggest appropriate controls related to valuing and reporting hard-to-value investments. As discussed later, the auditor is required to communicate significant deficiencies and material weaknesses in internal control, and may make suggestions for improvement.

Compliance activities

The plan administrator also has certain fiduciary responsibilities with respect to compliance activities. The audit process can help the plan avoid or detect common compliance errors in plan administration such as failure to:

- make timely remittance of deferrals
- use the proper definition of compensation
- properly apply forfeitures
- follow participant loan rules
- include all eligible employees
- follow hardship rules
- properly handle uncashed checks
- properly administer automatic enrollment
- issue minimum required distributions
- amend a plan for legislative changes.

In addition, auditors can assist plan administrators in understanding parties-in-interest and the related rules, which may help them avoid entering into prohibited transactions.

Financial reporting

As mentioned earlier, the plan administrator is responsible for filing a complete and accurate annual return/report for the plan on a timely basis. This includes, among other things, making sure proper accountabilities have been established for preparing the financial statements and disclosures and the Form 5500, and that proper investment valuation methodologies are used. The auditor can help the plan administrator with many aspects of the financial reporting process, including:

- Whether a proper certification is obtained from a qualified institution for electing the limited scope exemption in ERISA 103(a)(3)(C)
- Understanding the SOC 1 reports obtained from service providers, including applicable user controls contained within the report(s), any exceptions found in the testing by the service auditor and the impact on the plan, carved out subservice providers not covered by the SOC 1 report which may be relevant to plan operations, and the type of opinion issued by the service auditor and the implications of anything other than an unqualified opinion
- Understanding and evaluating investment valuations and disclosures
- Understanding actuarial reports (defined benefit plans and certain health and welfare plans)
- Understanding appraisal reports (employee stock ownership plans (ESOPs))

<u>Assertions Regarding the Plan Financial Statements</u>

Among other things, the plan administrator will be asked to provide written representations acknowledging its responsibility for the fair presentation in the financial statements of net assets available for benefits, changes in net assets available for benefits and, when applicable, statement of benefit obligations and statement of changes in benefit obligations in conformity with the applicable reporting framework. In making these representations, the plan administrator implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of the financial statements and related disclosures.

By actively participating in the audit process plan administrators will be better able to make proper assertions relevant to the amounts, transactions and disclosures reported in plan's financial statements, including:

- Appropriate and accurate participant data, including payroll information, is being utilized in determining amounts contributed to the plan.
- 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
- The allocation of net assets to the individual participant accounts in accordance with the plan document
- Investments and investment transactions are initiated and maintained in accordance with the established investment policies and comply with plan provisions.
- Participant loans (notes receivable) are initiated in accordance with the plan's provisions.
- Benefit payments are in accordance with the plan provisions and related documents for benefit payments, hardship withdrawals, in-service withdrawals, and qualified domestic relation orders.
- Expenses are paid in accordance with service provider agreements and the plan provisions and are properly authorized.
- 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).
- Plan transfers and plan terminations are recorded in accordance with plan provisions and other legal documentation and in the proper period.
- When there is a change in service providers (payroll, recordkeeper, trustee, or custodian), investment balances, other assets and liabilities, payroll information, and participant information and individual participant accounts transferred between service providers is complete and accurate.
- The trust is qualified under the Internal Revenue Code (IRC) as being exempt from federal income taxes and whether transactions or events have occurred that might affect the plan's qualified status

Auditor Communications

Auditor communications can provide immense value to the plan administrator. Auditors are required to communicate significant audit findings at various stages throughout the audit process that can help plan administrators improve plan operations and meet their fiduciary responsibilities to plan participants. In addition, auditors often make additional communications about issues noted during the audit and recommendations for improvement that help improve the plan administrator's awareness of potential risk for misstatements in the financial reporting process.

Communications with "those charged with governance"

Auditors are required to make certain communications to "those charged with governance" – that is, the person(s) with responsibility for overseeing the strategic direction of the plan and obligations related to the accountability of the plan. Persons charged with governance can expect to receive communications from the plan auditor – either verbal or written – at various stages during the audit process, as the communications should be performed on a sufficiently timely basis to enable those charged with governance to take appropriate action, when needed.

At the beginning of the audit, the communications include:

- The auditor's responsibility under generally accepted auditing standards (GAAS)
- The planned scope and timing of the audit

During the audit, the auditor will communicate:

- Significant findings and issues from the audit
- Difficulties or disagreements with management and/or third party providers

Communications made at the end of the audit include:

- Significant findings and issues from the audit
- Any management letter comments
- Communications about internal control related matters
- Uncorrected misstatements to the financial statements
- Material audit adjustments to the financial statements
- Significant issues that were discussed with management

Communications about internal control related matters identified in an audit

In performing an audit of a plan's financial statements, auditors are required to obtain an understanding of the plan and its environment, including its internal control. In doing so, they may become aware of matters related to the plan's internal control that may be considered deficiencies in internal control, significant deficiencies or material weaknesses.

Auditors are required to communicate to management and those charged with governance, in writing, significant deficiencies and material weaknesses identified during the audit no later than 60 days following the financial statement issuance date (or within 45 days for plans that file a Form 11-K with the SEC). Although the auditor is not required to make recommendations for improving internal control, they are not precluded from making such recommendations, and many auditors do.

Management letters

Even if plan auditors do not identify material weaknesses and/or significant deficiencies in internal control that would require written communication with management or those charged with governance, they may wish to communicate deficiencies in internal control or other issues or recommendations for improvement noted during the audit. Such comments generally are included in a "management letter." Management letters generally would document the deficiency in internal control or other issue and include a recommendation for remedying the situation.

Conclusion

In conclusion, we believe EBSA can and should expand on its efforts to increase the knowledge and understanding of the plan administrator of getting the most from the financial statement audit to meet their fiduciary responsibilities and to improve plan operations. In addition, the DOL should encourage plan administrators to look for quality auditors who can provide effective communications, and to seek out information and assistance from their auditors in these important areas.

Thank you for the opportunity to present our views and recommendations.

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Appendix A: Advance Materials Provided to the ERISA Advisory Council

AICPA

Employee Benefit Plan
Audit Quality Center

May 24, 2019

Larry Good
Executive Secretary
ERISA Advisory Council

Submission of Advance Material for June 25 ERISA Advisory Council Hearing:
Beyond Plan Audit Compliance: Improving the Financial Statement Audit Process

On behalf of the Employee Benefit Plan Audit Quality Center (EBPAQC) of the American Institute of Certified Public Accountants (AICPA) we submit the following information to the Advisory Council in advance of the June 25 hearing at which we will be providing our written and oral testimony. We believe this information will provide helpful background information on the financial statement audit process, including the plan administrator's role in that process. This information will help the Advisory Council identify actions the Secretary of Labor may take with respect to increasing the knowledge and understanding of the plan administrator that procures financial statement audit services, and on improving the procedures that such plan administrators implement in selecting an auditor; preparing for the audit; communicating with the auditor before, during, and after the audit; and adopting changes in the plan's documentation, operations, policies, or procedures based on the results of the audit.

Plan administrators have certain fiduciary responsibilities for the plan's financial reporting and operations. The AICPA EBPAQC has issued eight plan advisories that assist plan sponsors, administrators, and trustees in understanding their fiduciary and other responsibilities that are relevant to the plan audit. They discuss those responsibilities and provide information about and best practices for meeting those responsibilities, including discussions of how the audit process can help plan administrators meet their fiduciary responsibilities and improve the effectiveness of the plan's operations.

- Employee Benefit Plans—Financial Statement Audits
  Provides an understanding of the plan financial reporting and audit process and management's related responsibilities; the purpose, objectives and benefits of the independent audit; the auditor's responsibility for ERISA, DOL and IRS compliance and fraud detection; the audit process; and the plan administrator's role in the audit process.

- The Importance of Hiring a Quality Auditor to Perform Your Employee Benefit Plan Audit
  Provides an understanding of the importance of an employee benefit plan financial statement audit and of hiring a quality auditor, including the risks to the plan sponsor if a quality audit is not performed. It also provides information to help select a quality auditor.

- Understanding Auditor Communications
  Provides an understanding the various communications that plan management may expect from auditors during all phases of the audit. Such communications include significant findings and issues from the audit and other information shared with "those charged with governance"; engagement letters and management representation letters; communications about internal control related matters identified in the audit; and management letters and verbal communications. Most importantly, it includes a discussion of how auditor communications can help plan administrators improve plan operations and meet their fiduciary responsibilities to plan participants.

- Limited Scope Audits of Employee Benefit Plans
  Provides an understanding of limited scope audits of employee benefit plans under ERISA, including the statutory and regulatory basis for such audits; what constitutes a proper certification; and the plan administrator's responsibilities for determining the acceptability of a limited scope certification and whether the certifying institution is a "qualified institution"; and an example limited scope certification.

- The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets
  Provides an understanding how internal control over financial reporting is critical to the plan; how to establish cost-effective internal control; the importance of monitoring controls; plan auditor communications of internal control deficiencies; and how the plan auditor can help the plan administrator improve the effectiveness of the plan's system of internal control.

- Effective Monitoring of Outsourced Plan Recordkeeping and Reporting Functions
  Provides an understanding of the plan administrator's responsibilities for selecting and monitoring service organizations, and the benefits of establishing an effective monitoring program over service organizations that perform recordkeeping and reporting functions for an employee benefit plan.

- The Importance of Retaining and Protecting Employee Benefit Plan Records
  Provides an understanding of the importance of properly maintaining plan records, including retention requirements under ERISA; the plan administrator's responsibilities and best practices for records retention and protecting personally identifiable and other sensitive information; and the implications for failure to adequately retain and protect such information.

- Valuing and Reporting Plan Investments
  Provides an understanding of the plan sponsor's responsibilities for valuing and reporting plan investments; special considerations for alternative investments; investment information the plan administrator should request from the plan trustee or custodian and investment manager; and how the plan auditor can assist the plan administrator in valuing and reporting plan investments.

We ask that this advance material be included as part of our testimony submission.

We look forward to the opportunity to testify on June 25 before the ERISA Advisory Council.

Ian MacKay

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