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Examples of risks of material misstatement - ESOPs

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

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Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures.

To aid auditors in meeting this requirement, this document includes examples of RMM in an employee stock ownership plan (ESOP) financial statement audit which are excerpted from chapters 3, 5B, 8 and 9 of the AICPA Audit and Accounting Guide, *Employee Benefit Plans* (the EBP Guide). **These examples do not include all RMM that could apply or be relevant when auditing an ESOP.**

Refer to chapter 3 of the EBP Guide for guidance on performing the audit risk assessment, and chapters 5B, 8 and 9 for relevant assertions defined by audit area and example audit procedures to consider in addressing identified risks.

RMM at the financial statement level

The following are potential pervasive risks for employee benefit plan audits at the financial statement level:

- Lack of oversight and monitoring of plan operations and service providers
- Lack of financial reporting expertise
- Lack of communication about plan events between the preparer of the financial statements and others in the plan sponsor organization, such as treasury, finance, and human resources
- Lack of segregation of duties and safeguarding assets
- Changes in service providers
- Changes in human resource information system or payroll system
- Changes in plan personnel

- Lack of Employee Retirement Income Security Act of 1974 (ERISA) counsel involvement
- Decision to terminate or curtail the plan
- Plan amendments
- Sale of plan sponsor
- Financial difficulty of the plan sponsor or contributing employers
- Susceptibility of plan assets to theft or fraud (even if specific RMM due to fraud are not identified, paragraph .32 of AU-C section 240 states that a possibility exists that management override of controls could occur. For example, even where a service organization reports are used as a plan's general ledger, management may be able to direct the service organization to record adjustments and nonstandard, journal entries outside of the normal accounting process or routine plan operations.
- Plan transfers (plan mergers, spin-offs, or other transfers)

RMM at the relevant assertion level for classes of transactions, individual account balances, and disclosures

Participant accounts and allocations

- Allocations of shares, contributions, dividends, forfeitures, or expenses may be inaccurate, causing the participant's account to be overstated or understated.
- The release of shares from collateral for allocation to participants' accounts and presentation in the allocated column may not be in accordance with the ESOP loan document and the prohibited transaction exemption regulations.
- A reconciliation between the recordkeeper and the ESOP financial statements for shares released to participant accounts is not performed. Improperly prepared reconciliations of the release of shares by management could result in improper allocations.
- Dividends on employer stock may not be properly allocated to participants in accordance with participant elections, when such an election is available under the terms of the plan document.
- Dividends on shares allocated to participants used for debt service improperly result in the allocation of shares in an amount less than the amount of dividends applied.
- Dividends on employer stock may be inappropriately allocated to disqualified participants. In item a in paragraph B-45 of appendix B of this chapter discusses the requirements to comply with IRC Section 409(p) and the implications for an ESOP sponsored by an S corporation to have an uncertain tax position.
- Forfeited plan assets pending allocation to participant accounts may be improperly excluded from total plan assets, causing plan assets to be understated.
- Diversification distributions may not have been properly calculated or may not have been made in accordance with the participant's election or in the proper period.

Cash balances

- Certain cash accounts, such as cash clearing accounts, suspense accounts, or cash disbursement accounts, may be omitted from the financial statements because these accounts may or may not be included in the trust statements. Cash accounts owned and controlled by claims processors may be improperly recorded as cash of the plan. When cash balances are properly included, cash transactions or balances in bank statements may not reconcile to the plan's financial statements, or

ending cash balances from the prior year may not agree to beginning cash balances in the current year.
- Plans may have significant amounts of cash held by the trustee or custodian outside of the plan due to uncashed checks. This cash may not be properly accounted for in the plan's financial statements.

Investments and related income

- Investments recorded in the financial statements do not exist or are not owned by the plan or have not been properly transferred to the plan.
- Investment information from the trust (custody) statement does not reconcile to the plan's records, trial balance, financial statements or record keeper.
- Investment transactions are not recorded by the trustee (custodian) or are not recorded on a timely basis.
- Investment purchases and sales transactions involving employer stock are not properly authorized prior to initiation or are not in accordance with the plan provisions.
- Investment purchases and sales transactions involving employer stock are not in accordance with the plan provisions which could result in a nonexempt transaction under the laws and regulations (IRC and ERISA). See paragraphs B-28–B-31 of appendix B of this chapter.
- Gains and losses on sales of investments are calculated incorrectly.
- Dividend income, including pass through dividends, is recorded at an incorrect amount.
- The valuation of investments in privately held employer stock is not supported by a valuation report as of the annual reporting date (generally the last day of the plan year).
- Transactions occurring during the year between the ESOP and a party in interest to purchase or sell shares of privately held stock are not supported by a valuation report as of the actual trans-action date and there is no "bring down" or "roll forward" letter to the actual transaction date.
- ESOP's trustee, administrative committee, or other ESOP fiduciaries do not have a process for the valuation of privately held employer stock, including their selection of an appraiser, verification of the appraiser's independence and competence, and evaluation of the inputs and assumptions used by the appraiser.
- The appraiser selected by the ESOP's trustee, administrative committee, or other ESOP fiduciary does not have the appropriate qualifications or related experience to perform the valuation of the privately held employer securities.
- Valuation reports for privately held employer stock may not appropriately reflect fair value in accordance with GAAP due to the use of inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate or inappropriate inputs or assumptions and the application of those inputs or assumptions. For example:

    i. Inputs or assumptions that are susceptible to misapplication or management bias.

    ii. Inputs or assumptions that are unreasonable and inconsistent with market information and the past experience of the employer as reported in financial statements of the employer

    iii. Valuation methods that are assigned greater weighting without proper explanation or consideration and exclusion of applicable valuation approaches

    iv. Valuation methods that are not standard or accepted methodologies

    v. Valuation methods that are not consistently applied period to period and significant changes in inputs to the valuation model

    vi. Changes in appraisers, resulting in inconsistencies in valuation methodologies or modifications of the assumptions from those used by the previous appraiser without justification due to changing business or market conditions

    vii. The effect of the put obligations, deferred obligations, diversification or other funding arrangements on the plan sponsor's liquidity

- For leveraged ESOPs, relevant investment activity is not properly presented in the financial statements in the applicable allocated or unallocated column. Relevant investment transactions include:

  i. Dividends, including pass through dividends

  ii. Unrealized appreciation or depreciation

  iii. Purchases or sales transactions

Contributions and certain participant data (nonleveraged ESOPs and ESOPs with 401(k) features)

- Employees are not appropriately included or excluded based upon the plan's provisions (for example, age or service requirements not met or part-time or leased employees).
- Employer or employee contributions are not properly calculated, authorized, or recorded in the proper period.
- Employee and employer contributions are incorrect due to the use of a definition of compensation different than what is specified in the plan's provisions, including the application of true-up contributions.
- Contributions are not accurate, complete, or remitted in accordance with the plan's provisions (for example, manual checks, special pay, or bonuses).
- Participant deferral percentages entered into payroll are inaccurate, including catch-up contributions elections for participants over age 50.
- Profit sharing contributions or ESOP allocations are not properly recorded.
- Incorrect compensation or hours is used to determine contributions.
- For multiemployer DC plans, participant contributions are not remitted in accordance with the collective bargaining agreement.
- Excess contributions such as failure to pass the actual deferral percentage test are not properly determined or recorded.

Contributions and contributions receivable (leveraged ESOPs)

- Employees are not appropriately included or excluded based upon the plan’s provisions (for example, age or service requirements not met or part-time or leased employees).
- Contributions are not properly calculated, authorized, or recorded in the proper period.
- Contributions are incorrect due to the use of a definition of compensation different than what is specified in the plan’s provisions including the application of true-up contributions.
- True-up contributions not properly made when dividends are used for debt service and do not satisfy the return for value standard.
- Contributions are not accurate, complete, or remitted in accordance with the plan’s provisions (for example, manual checks, special pay, or bonuses).
- Dividends on unallocated shares are improperly considered to be employer contributions.
- Contributions receivable are recorded on the plan’s financial statements so the amount will agree with the contribution payable in the employer’s financial statements in cases when it may not be appropriate for the amounts to agree.
- When contributions related to debt service on ESOP loans from the employer are not paid in cash, but are made by journal entry only, loan terms and regulatory requirements may not be followed causing inaccurate reporting of contributions.
- Contributions are classified incorrectly between allocated and unallocated.
- Contributions receivable that represent principal and interest payments on debt service are improperly classified in the allocated or unallocated column.

Forfeitures

- Forfeitures are incorrectly allocated to individual participant accounts and, in the case of a KSOP, allocated to the incorrect investment funds.
- Non-vested amounts are incorrectly calculated.
- To the extent that a participant's account includes other assets in addition to employer securities, the other assets are not properly forfeited prior to the forfeiture of any employer securities.
- When a participant's account includes employer securities of different classes, forfeitures are not properly pro-rated for each class of security based on their legal attributes, such as common or preferred and voting or non-voting stock.
- Participant accounts are forfeited prior to the complete distribution of the participant's vested interest in the plan or the completion of a five-year consecutive break in service.
- Forfeitures are not used in accordance with the plan document or applicable regulations. Misuse of plan forfeitures may result in plan qualification issues, as well as possible fraudulent financial reporting.
- Participants are not 100 percent vested, as required by the regulations when a plan is deemed to have had a partial plan termination as a result of participants being involuntarily terminated.
- Disclosure of forfeitures may fail to include the amount and disposition of forfeited non-vested accounts, including identification of amounts that are used to reduce employer contributions, pay plan expenses, or reallocated to participants' accounts.

Notes payable and interest expense

- Loan payments are not made in accordance with the debt agreements.
- Loan prepayments are not properly recorded causing inaccurate reporting of principal and interest.
- Unallocated shares are not properly released when loan payments are made.
- When loan payments are not paid in cash, but are recorded by journal entry, loan terms and regulatory requirements may not be followed causing inaccurate reporting of principal and interest payments.
- Dividends may not be properly allocated in accordance with the terms of the debt agreement or to the wrong loan when the ESOP has multiple loans.
- Interest expense is not calculated in a manner consistent with the plan document or the debt agreement, for example

    i. failing to timely change the variable interest rate or applying the wrong 360/365 day method.
    ii. failing to apply prepayments according to loan provisions.
    iii. not making loan payments when due, causing the incorrect amount of interest to be paid.

- Payment date used for collateral release is not consistent with the actual loan payment date which could lead to inaccurate reporting and allocation in the financial statements.
- Inaccurate use of the principal or principal and interest method for share release based on the loan agreement and plan document provisions causing the participant accounts to be over or understated.
- Dividends on shares acquired through a contribution, a non-leveraged purchase or shares purchased with a prior loan that has been fully paid are inappropriately applied to debt service. Loan payments are limited to the earnings from shares acquired with that loan.

Employer advances

- The employer advance does not comply with the DOL Prohibited Transaction Class Exemption 80-26 for example

    i. interest was charged on the advance.
    ii. plan assets were pledged as collateral for the advance.
    iii. employer advances outstanding 60 or more days are not in writing.

- Repayment of employer advances by conversion to an employer contribution or transfer of other plan assets to the employer is not properly executed.

Participant benefits, distributions and withdrawals

- Benefit payments or withdrawals are not properly authorized or in accordance with the provisions of the plan document.
- Benefit payments or withdrawals to participants are not recorded or are recorded in the incorrect amount.
- Benefit payments per the trustee do not reconcile to amounts per the record-keeper.
- Benefit payments are calculated incorrectly (nonrecognition of prior diversification election or vested balance).
- Benefit payments are not in accordance with the participant's election (diversification or form and timing of distribution).
- Benefit payments are not recorded in the correct participant's account.
- Benefit payments are made to a participant who is not eligible to receive benefits.
- Put option transactions are improperly recorded in the ESOP financial statements.
- The distribution of shares are incorrectly recorded at the floor price rather than the fair value in accordance with GAAP.

Floor price protection

- Payments required under floor price protection are incorrectly recorded as a plan transaction (for example, as a contribution), rather than as a direct payment by the employer to the participant
- Incorrectly recording the distribution of shares at the floor price rather than the fair value
- Inaccurate or missing disclosures relating to floor price agreements.

Plan expenses

- Plan expenses do not represent allowable expenses per the plan document or regulatory provisions.
- Plan expenses are paid to fictitious vendors.
- Plan expenses are not properly accrued or classified.
- Plan expenses are not calculated in accordance with service provider agreements.
- Allocation of expenses between plans or the plan sponsor are not apportioned correctly.
- Plan expenses are not properly authorized prior to recording and payment.
- Plan expenses are not properly recorded by the trustee or custodian.

Terminating plans (full and partial) or frozen ESOP plans

- Plan terminations and terms or conditions of the transaction are not appropriately presented and disclosed.
- Participants are not properly vested.
- The ESOP stock is not valued as of the termination date.
- For a leveraged ESOP, the ESOP debt has not been satisfied, repaid, or otherwise settled in ac-accordance with the debt agreement and applicable laws and regulations.
- The financial statements have not appropriately applied the liquidation basis of accounting, when applicable. For GAAP purposes, this means that the financial statements are inappropriately prepared on a going concern basis when liquidation is imminent, or inappropriately pre-pared using the liquidation basis of accounting when liquidation is not imminent, as defined in FASB ASC 205-30.
- Benefit payments are not made only to, or on behalf of, persons entitled to them.
- New entrants have been admitted to the plan after the effective date of the plan freeze or termination.
- A partial plan termination is not properly recognized resulting in an understatement or over-statement of participant distributions.

Changes in service providers

- Amounts transferred between trustees and custodians are not accurate or allocated to the proper investment accounts.
- Participant data transferred between recordkeepers is not complete or accurate (for example, lost data or lost participants).
- Valuation methodology used by the new appraiser is not consistent with prior appraisals.
- Payroll information transferred between payroll service providers is not complete or accurate.
- Reconciliations are not completed between the predecessor service provider and new service provider.

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