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Examples of risks of material misstatement - defined benefit plans (including terminating and frozen DB plans)

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 a defined benefit (the EBP Guide). **These examples do not include all RMM that could apply or be relevant when auditing a defined benefit plan.**

Refer to chapter 3 of the EBP Guide for guidance on performing the audit risk assessment, and chapters 6, 8 and 9 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

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. When cash balances are 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

- Insurance contracts or investment contracts are not properly recorded at fair value as of the reporting date due to the use of inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate inputs.
- Investment details and presentation for assets held in 401(h) accounts are not properly accounted for or disclosed in accordance with the applicable financial reporting framework.
- Unallocated investment contracts with insurance companies are not properly included in plan assets based upon contract terms.
- Allocated investment contracts with insurance companies are not properly excluded from plan assets based upon contract terms.
- Investment information from the trust (custodian) statement does not reconcile to the plan sponsor's records (trial balance), financial statements, or other record-keeper.
- Investment manager or subcustodian reports do not reconcile to trustee (custodian) reports.

- Investment transactions are not recorded by the trustee (custodian) or are not recorded on a timely basis.
- Investment purchase and sale transactions are not properly authorized prior to initiation or are not in accordance with the plan provisions or investment policies.
- Investments recorded in the financial statements do not exist or are not owned by the plan.
- Gains and losses on sales of investments are calculated incorrectly.
- Investment income is recorded at an incorrect amount.
- Investments are not properly recorded at fair value as of the reporting date due to the use of inappropriate valuation methodologies, mathematical errors in the application of the methodology, or inaccurate inputs.
- Investment details (such as type of investment, name of issuer, CUSIP, investment identification, number of shares, maturity date, or interest rate) are incorrectly entered into the investment management system upon purchase.

Contributions and contributions receivable

- Employees are not appropriately included or excluded based upon the plan's provisions (for example, age or service requirements are not met or part-time or leased employees).
- Employer contributions are not properly calculated or authorized, do not meet minimum funding requirements, or exceed maximum allowed funding limits.
- The contribution range determined by the actuary is misstated due to unreasonable assumptions, asset values in the actuarial valuation report are incorrect or unfunded, or amounts are not amortized or are amortized over an incorrect period.
- Contribution amounts per plan sponsor records do not reconcile to the trust statements and actuarial valuation.
- Contributions receivable are not recorded or are recorded in the incorrect period.
- Employer contributions are delinquent or uncollectable. (This is a common issue for multiemployer plans.)
- Improper accounting for amounts owed to the plan by participating employers who have withdrawn from a multiemployer plan.
- Differences between employer contribution amounts reported in the financial statements, the actuarial report, or Schedule SB or MB of the Form 5500 are not appropriately evaluated.

Other receivables

- Interest and dividends receivable are not properly accrued.
- Income resulting from securities lending is not properly accrued.
- Amounts due from brokers for securities sold is not properly recorded.
- Derivative-related activity, such as receivables for variation margin and foreign currency forward contracts, is not properly recorded.
- Reimbursements from the plan sponsor or service providers for fees, operational defects, or lost income are not properly recorded.
- Receivables due for legal settlements not properly recorded

Operating assets

- Detailed property records are not periodically reconciled to the recorded amounts.
- Assets are improperly expensed and not in accordance with capitalization policies.
- Depreciation is not calculated properly or not properly recorded in the financial statements.
- Assets used both in operations and for investment purposes are accounted for improperly.
- Improper accounting recognition of an impaired asset.

Accrued liabilities

- Amounts due to brokers for securities purchased are not properly recorded.
- Unpaid administrative fees (for example, for actuaries, auditors, trustees, or ERISA counsel) are not appropriately accrued in the proper period.
- Investment management fees are not appropriately accrued in the proper period.
- Benefits payable are incorrectly recorded as a liability in the statement of net assets available for benefits instead of as an obligation in the statement of accumulated benefit obligations.
- Litigation settlements are not properly accounted for as an obligation.

Benefit payments

- Benefit payment calculations are based on incorrect census data or incorrect actuarial inputs or calculated incorrectly or not in accordance with the participant's benefit election. (It should be noted that benefit calculations can be performed either by the plan sponsor or a third party, such as the plan's actuary.)
- Benefit payments are not properly authorized or in accordance with the provisions of the plan document.
- Benefit payments are made to a participant or beneficiary who is not eligible to receive benefits.
- If the plan sponsor has more than one DB plan, payments could be made out of the wrong plan.
- Fictitious or duplicate benefit payments are recorded.
- The formula used to compute the benefit does not agree to plan provisions, including the definition of compensation, or options selected by participants.
- Changes to the payroll data (including new hires, terminations, compensation changes, and variable compensation arrangements) are not properly authorized or accurately recorded as a result of fraudulent changes, unauthorized changes, or inaccurate processing of changes, resulting in incorrect data being sent to the payroll processing service provider or actuary from the payroll system.
- Benefits paid per the trustee do not agree to benefits paid per the actuary.

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 between plan sponsors is 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.

Accumulated plan benefits

- The actuary does not have the appropriate qualifications or related experience to perform the valuation.
- Participant groups are inappropriately excluded from, or included in, the census data.
- If a plan sponsor maintains multiple DB plans, participants may not be reflected in the appropriate plan's census data and accumulated plan benefits.
- Benefits paid per the actuary do not agree with benefits paid per the trustee or plan sponsor.
- Interest allocation computation for cash balance accounts does not agree with plan provisions.

- Participant data used by the actuary does not reconcile to the plan sponsor's payroll and personnel records, such as beginning of the year versus end of the year information.
- The plan's actuary maintains incomplete or incorrect census data or uses inappropriate factors or assumptions, causing inaccurate computations and errors in the accumulated plan benefits.
- The actuary calculates the accumulated plan benefits as of an incorrect valuation date.
- Participant contributions are not properly included in actuarial data.
- Accumulated benefit obligations of a 401(h) account are incorrectly included with the pension benefit obligation, and not in the health and welfare plan's obligation.
- Accumulated plan benefit assumptions are not based on the plan provisions or plan experience, or they are inappropriate or unreasonable.
- Identified operational errors are not appropriately communicated to the actuary, which may result in an overstatement or understatement of the calculation of the accumulated benefit obligation.
- Participants who have requested a lump sum distribution at or near year-end but have yet to be paid are erroneously deleted or omitted or improperly removed from the census data.
- Plan amendments have not been properly included or excluded, depending on the valuation date.
- Plan sponsor does not maintain adequate records for accumulated benefit or benefit payments

Plan transfers (plan mergers, spin-offs, and other transfers)

- Plan transfers occurred without appropriate authorization.
- Plan transfers are not recorded in the proper period.
- Appropriate assets, liabilities, and total accumulated plan benefit obligations are not properly transferred and do not reconcile between plans.
- The total accumulated plan benefit obligations of the prior plan are not complete and accurate.
- Recurring benefit payments (if applicable) of the prior plan that will continue to be paid by the successor plan are not complete and accurate.
- Participants' information is not transferred accurately between plans (for example, demographic and other census data and hypothetical account balances).
- Plan transfers are not fairly presented in the financial statements and not appropriately disclosed.

Terminating plans (full or partial) or frozen DB plans

- Plan terminations are not appropriately disclosed.
- The financial statements have not appropriately applied the liquidation basis of accounting, when applicable. This means that the financial statements are prepared on a going concern basis when liquidation is imminent, or prepared 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.
- Service accruals have continued beyond the effective date of the plan freeze.
- For a hard freeze, salary increases have continued to be applied to a frozen benefit.
- For a soft freeze, which allows for continued salary increases to apply, updated salaries have not been used in the actuarial valuation.
- Participant data used by the actuary does not reconcile to the plan sponsor's payroll and personnel records.
- The plan's actuary uses incomplete or incorrect census data, causing inaccurate computations and errors in benefit payments and estimating funding and benefit obligations.

- Participants were improperly excluded from or included in the census prior to the plan freeze.
- Plan sponsor does not maintain sufficient records to support the estimated benefit obligations or benefit payments.

Changes in service providers

- Change in service provider occurred without appropriate authorization.
- Assets and liabilities transferred between trustees or custodians are not complete and accurate or allocated to the proper investment accounts.
- Participant data transferred between actuaries or recordkeepers is not complete or accurate (for example, inaccurate demographic data, lost data, lost participants, or data only in summary form).
- Payroll information transferred between payroll service providers is not complete or accurate.
- Benefit obligations are not calculated on a consistent basis by the successor actuary.
- Census data used by the predecessor actuary was not complete or was inaccurate.

Plan's tax status

- The plan document is not timely implemented, updated, or amended.
- Plan operations do not stay current with changes in governing law.
- Required amendments for regulation changes are not made in the year following the change, as allowed.
- Failure to properly apply the plan's provisions, such as:
    i. excluding eligible employees or including ineligible employees (for example, the definitions of employee and employer are not followed, missed entry date, or entry allowed too early).
    ii. vesting errors (for example, improper application of years of service).
- Failure to make corrections required to comply with annual compliance tests.

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