Examples of risks of material misstatement - defined contribution 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.

In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

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 contribution plan financial statement audit which are excerpted from chapters 3, 5, 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 a defined contribution plan.**

Refer to chapter 3 of the EBP Guide for guidance on performing the audit risk assessment, and chapters 5A, 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

- Participant investment options or salary deferral amounts may not be in accordance with their stated elections, causing the participant's account to be overstated or understated.
- Allocations of income or expenses may be inaccurate, causing the participant's account to be overstated or understated.
- Lack of reconciliations or improperly prepared reconciliations by management could result in missing contributions or improper allocations.
- For self-directed brokerage accounts, a lack of reconciliations between the trustee, the record-keeper and the brokerage firm could result in incomplete or inaccurate reporting.
- For self-directed brokerage accounts, fees being charged for recordkeeping are not applied correctly.

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 investment income

- 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.

- Fully benefit-responsive investment contracts are not properly recorded at contract value as of the reporting date.
- 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.
- 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.

Notes receivable from participants (loans)

- Loans are not initiated in accordance with the plan's provisions and, therefore, are not recorded properly.
- Loan details (such as amount, repayment period, interest rate, and residential or nonresidential loan) are incorrectly entered into the recordkeeper system.
- Loan repayments are not properly calculated or properly withheld from payroll on a timely basis.
- Loans are not reconciled between the recordkeeper and trustee on a timely basis.
- Loan repayments are not recorded in the correct individual participant's account.
- Delinquent loans or loans in default are not identified on a timely basis and are not accounted for in accordance with GAAP.
- In a plan merger, loans are not properly transferred to the new plan from the existing plan.

Contributions and contributions receivable (including rollover contributions)

- 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 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.

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 are not properly recorded.

Forfeitures

- Forfeitures are incorrectly allocated to individual participant accounts or investment funds.
- Unvested amounts are not calculated correctly.
- 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
- A plan can have a partial termination in which 20 percent or greater of the participants have been involuntarily terminated, and participants are not 100 percent vested, as required by the regulations.

Accrued liabilities

- Amounts due to brokers for securities purchased are not properly recorded.
- Unpaid administrative fees (for example, for auditors, trustees, or ERISA counsel) are not appropriately accrued in the proper period.
- Investment management fees are not appropriately accrued in the proper period.
- Current benefits payable are incorrectly recorded as a liability.
- Corrective distributions are not properly recorded in the current period.

Participant benefits, distributions and withdrawals

- Benefit payments or withdrawals are not properly authorized or in accordance with the provisions of the plan document.
- Payment of benefits or withdrawals to participants are not recorded or are recorded in the incorrect amount.
- Benefit payments per trustee do not agree to amounts per the recordkeeper.
- Benefit payments are calculated incorrectly (nonrecognition of loans or vested balance).
- Benefit payments are not in accordance with the participant's election.
- Benefit payments are not recorded in the correct individual participant's account.
- Benefit payments are made to a participant who is not eligible to receive benefits.

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.

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

- Plan transfer occurred without appropriate authorization.
- Plan transfers are not recorded in the proper period.
- Appropriate assets, liabilities, and total accumulated benefits of individual participant accounts are not properly transferred and do not reconcile between plans.
- The total accumulated benefits of individual participant accounts 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 data and participant investment elections).
- Plan transfers are not fairly presented in the financial statements and not appropriately disclosed.
- Plan transfers cause delays in remitting participant salary deferrals, which could also result in a prohibited transaction.

Terminating plans

- Plan terminations are not appropriately disclosed.
- The financial statements have not appropriately applied the liquidation basis of accounting, when applicable. For GAAP purposes, 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.

Changes in service providers (payroll, recordkeeper, trustee, or custodian)

- 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.

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. the definition of compensation used operationally is different from the plan document (for example, improper inclusion or exclusion of compensation for plan purposes or improper period considered for newly eligible employees).
    ii. 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).

iii. incorrect employer matching contributions.
iv. participant elections (for example, error in setup of participant elections, failure to restart subsequent year contributions after limits are met, and excess elective deferrals).
v. vesting errors (for example, improper application of years of service).
vi. errors in applying automatic deferral rates (for example, failure to set up automatic deferral rates or failure to implement rate escalation).
vii. distributions (for example, improper hardship determinations, failure to make minimum required distributions, or partial termination vesting errors).
viii. plan loans (for example, the plan document does not allow for loans, but loans are extended; the failure to withhold loan payments; or loans exceed plan or IRC limits).

- Failure to perform or incorrectly performing nondiscrimination and other operating tests.
- Failure to recognize that the plan is a member of a controlled group.
- Failure to make corrections required to comply with annual compliance tests.
- Failure of a VEBA to test its reserve accumulations and exposure to UBTI.
- Failure to assess whether any plan investments generate UBTI.

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