

Limited Scope Audits Of Employee Benefit Plans

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Topix Primer Series

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Introduction

The AICPA Employee Benefit Plan Audit Quality Center has developed this primer to provide a general understanding of limited scope audits of employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA). This document provides a general description of the statutory and regulatory basis for the limited scope audit exemption, proper certifications from qualified institutions, the plan administrator's responsibilities, the limited scope audit in the current environment, and the effect of the limited scope audit exemption on the scope of the independent auditor's testing and reporting.

Statutory and Regulatory Basis

Congress and the U.S. Department of Labor permit limited scope audits of ERISA plans.

In 1974, Congress enacted ERISA to help protect retirement benefits for workers covered by private pension plans. In addition to establishing minimum standards for benefit accrual, funding and vesting, ERISA section 103(a)(3) required employee benefit plans to be audited by an independent qualified public accountant. However, ERISA section 103(a)(3)(C) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency, that acts as trustee or custodian.

ERISA's independent audit requirements are administered and enforced by the U.S. Department of Labor (DOL). The DOL issued implementing regulations in 29 CFR 2520.103-8 - *Limitation on scope of accountant's examination*, which established regulatory requirements to meet the limited scope audit exemption.

The U.S. Securities and Exchange Commission does not permit limited scope audits to be included with Form 11-K filings with the SEC under the Securities Exchange Act of 1934.

Qualified Institutions

Only qualified institutions can certify information.

The DOL established requirements for qualifying institutions to certify information to the plan administrator in 29 CFR 2520.103-5 - *Transmittal and certification of information to plan administrator for annual reporting purposes*. Under DOL regulations, investments held by a bank, trust company, or similar institution or by an insurance company that is regulated and subject to periodic examination by a state or Federal agency, and related information do not have to be audited provided the plan administrator elects to instruct the plan's independent auditor to perform a limited scope audit and the institution holding the assets certifies the required information.

In an Advisory Opinion to PaineWebber Inc. dated August 3, 1993, the DOL clarified that an institution must be subjected to routine examinations by a state or Federal agency in order to be considered a qualifying institution for purposes of certifying investment information and, as such, an institution that is not regulated would not qualify:

“Inasmuch as securities brokerage firms are not regulated, supervised, and subject to periodic examination by a state or Federal agency, it is the Department’s position that the term “similar institution,” as used in 29 C.F.R. § 2520.103-8, does not extend to such entities.”

Although brokerage firms and investment companies generally would not meet the eligibility requirements for certifying information under the limited scope audit exemption, some of those institutions may have established separate trust companies that could meet the requirements to be a qualified institution.

Proper Certifications

Information must be certified as both complete and accurate and signed by an authorized person.

To meet the requirements for the limited scope audit exemption, the qualified institution must certify both the completeness and accuracy of the required information, and the certification must be signed by a person authorized to represent the institution. An example of such certification follows:

The XYZ Bank (Insurance Carrier) hereby certifies that the foregoing statement furnished pursuant to 29 CFR 2520.103-5(c) is complete and accurate.

Certifications that only state the information is either accurate or complete, but not both, or are not signed by an authorized individual do not meet the DOL requirements for a proper certification.

In situations where a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, the plan administrator would need to obtain separate individual plan certifications from the trustee or the custodian for the allocation of the assets and the related income activity to the specific plan.

In some cases, the trustee or custodian may not certify all of the plan’s investment information. For example, the trustee or custodian may exclude investments from the certification, or plan management may change trustees or custodians during the plan year so each trustee or custodian held the assets for part of the year, and only one of the trustees or custodians will certify investment information for part of the year.

Plan Administrator’s Responsibilities

The plan administrator is responsible for determining that the conditions of the limited scope audit have been met and for preparing the plan’s financial statements and disclosures.

Only the plan administrator can request the plan auditor to limit the scope of the audit when all requirements are met. The plan administrator is responsible for determining that the conditions of the limited scope audit exemption have been met. The DOL reinforced this position in a letter addressed to the AICPA in 2002:

“Consistent with the obligation of employee benefit plan administrators to file complete and accurate annual reports, it is the responsibility of the administrator to determine whether the conditions for limiting the scope of an accountant’s examination, as set forth in ERISA and the department’s regulations, have been satisfied.”

The plan administrator’s responsibility for the plan’s financial statements includes determining that the certification is from a qualified institution and signed by an authorized person, and that the investment information is certified as both complete and accurate.

It is important that the plan administrator review the certified investment information to determine that the investments have been valued as of the plan’s year-end and that the method for determining their fair value is in conformity with U.S. generally accepted accounting principles as promulgated by the Financial Accounting Standards Board (FASB), and appropriate for reporting to the DOL on the Form 5500.

If the plan administrator determines that the certification is not acceptable, he or she would need to take appropriate steps to obtain an acceptable certification or engage the independent auditor to perform a full scope audit.

If investments are excluded from the certification as discussed in the “Proper Certifications” section above, those assets would not be eligible for the limited scope audit exemption. In such cases, the plan administrator would be responsible for engaging the independent auditor to perform audit procedures on the investments excluded from the certification.

Effect on the Audit Scope and Testing

A limited scope audit restricts testing of certified investment information, but audit procedures need to be performed on other non-investment information.

When the auditor is instructed by the plan administrator to perform a limited scope audit, the auditor has no responsibility to test the accuracy or completeness of the investment information certified by the plan’s trustee or custodian, obtain an understanding of internal control maintained by the certifying institution over investments held and investment transactions executed for the plan, or assess control risk associated with assets held and transactions executed by the institution. As such, the auditor would not need to obtain or review a SOC 1 report from the plan’s certifying trustee or custodian relating to the certified investments.

Plan investments not held by a qualified trustee or custodian and any other investment or investment information not covered by the certification, including investment elections and income allocations to participant accounts should be subjected to appropriate audit procedures. This means that the independent auditor will perform audit testing—including understanding and documenting internal controls and assessing risks—on the non-investment activity of the plan, such as participant eligibility, employee and employer contributions, benefit payments, and plan administrative expenses. The AICPA Audit and Accounting Guide, *Employee Benefit Plans*, describes the independent auditor’s responsibilities in a limited scope audit.

Limited Scope Audits in the Current Environment

Challenging valuation issues have arisen with new and complex investment options.

When the limited scope audit exemption was established by ERISA in 1974 the majority of plan investments were held in common stocks, mutual funds, bonds and other instruments that were either directly held by the plan, or held in trust or custodial accounts at banks, insurance companies or similar institutions regulated by a Federal or state agency. Since ERISA was enacted, many plans have shifted their investments into more complex, hard-to-value investments, such as limited partnerships, private equity funds, and hedge funds. In today's environment, such investments are not necessarily held directly but rather may be held in a multi-layered investment such as a fund of funds, or as a piece of an original investment such as a derivative, thus making them more difficult to identify and value.

Because many plan custodians or trustees do not provide valuation services for their plan clients, the amounts certified by the institution may not represent the fair values of these hard-to-value investments. The contract with the trustee or custodian will indicate what information the plan sponsor receives. The typical custodial service provided by trustees and custodians includes providing values that are based on the best information available to them at the time the statements are produced. If the plan is invested solely in assets with readily determinable fair values, such as exchange traded securities, the trustee or custodian typically obtains fair values from nationally recognized pricing services. However, in cases where the plan invests in assets without readily determinable fair values, and where the trustee or custodian may have been engaged only to provide custodial services, the values in the trust statement may be a pass-through of the values provided by the fund issuer or general partner, or by a boutique vendor or broker for nonmarketable securities. In those cases, the reported values are based on the best information available to the trustee and custodian at the time the trustee or custodial report is prepared, which may or may not be fair value as of the plan's year end.

In addition to the increased complexity in plan investments, plan structures have also become much more complex. And as discussed in the "Proper Certification" section above, there are reasons why some assets may not be covered by a certification at all. As such, it is important that plan administrators evaluate whether these limited scope audit exemptions continue to make sense for their plan audits.

The Auditor's Report

An auditor would disclaim an opinion on the financial statements and supplemental schedules taken as a whole when performing a limited scope audit.

An independent auditor performing a limited scope audit generally would be unable to express an opinion on the financial statements and supplemental schedules taken as a whole due to the significant limitation on the scope of the audit. Following is an example of the auditor's report for a defined contribution pension plan, excerpted from the AICPA Audit and Accounting Guide, *Employee Benefit Plans*, for limited scope audits where the auditor believes the plan administrator's restriction on the auditor's examination to be a significant limitation on the scope of the audit.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of XYZ 401(k) Plan, which comprise the statements of net assets available for benefits as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter described in the *Basis for Disclaimer of Opinion* paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 20X2 and 20X1, and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Disclaimer of Opinion

Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on these financial statements.

Other Matter

The supplemental schedules [*identify schedules*] as of or for the year ended December 31, 20X2 are required by the Department of Labor's (DOL) Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and are presented for the purpose of additional analysis and are not a required part of the financial statements. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* paragraph, we do not express an opinion on these supplemental schedules.

Report on Form and Content in Compliance With DOL Rules and Regulations

The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with

auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Additional Resources

AICPA Audit and Accounting Guide, **Employee Benefit Plans**, provides information about the limited scope exemption and provides guidance on the auditor's responsibility when engaged to perform a limited scope audit.

The annual AICPA Audit Risk Alert, **Employee Benefit Plans Industry Developments**, highlights the hot topics in the employee benefit plan industry, including current issues with limited scope audits.

AICPA **Accounting Trends & Techniques—Employee Benefit Plans**, provides illustrative limited scope audit disclosures and auditor's reports.

The AICPA EBPAQC Plan Advisory **Valuing and Reporting Plan Investments** may serve as a tool to assist the plan sponsor in understanding their responsibility in valuing and reporting plan investments. The document is available on the Center Web site at www.aicpa.org/ebpaqc.

The EBPAQC **Limited Scope Resource Center** provides general information about limited scope audits, including links to authoritative information, archived Center calls and other Center tools. This resource center can be found on the Center Web site at www.aicpa.org/ebpaqc.

29 CFR 2520.103-8 – Limitation on Scope of Accountant's Examination, provides ERISA guidance on the limited scope audit exemption.

http://www.dol.gov/dol/allcfr/ebsa/Title_29/Part_2520/29CFR2520.103-8.htm

DOL **Advisory Opinion to Mr. Richard Bentley, Paine Webber Inc.**, dated August 3, 1993, clarifies definition of an institution qualified to issue a certification.

<http://www.dol.gov/ebsa/programs/ori/advisory93/93-21a.htm>

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