

**STATEMENT OF  
MARILEE LAU, CPA, AND  
MICHELE WELDON, CPA  
ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC  
ACCOUNTANTS**

**BEFORE THE  
U.S. DEPARTMENT OF LABOR ADVISORY COUNCIL  
ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS**

**EMPLOYEE BENEFIT PLAN AUDITING AND FINANCIAL REPORTING MODELS**

**JUNE 29, 2010**

I am Marilee Lau, Chair of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center Executive Committee, and with me is Michele Weldon, Chair of the AICPA Employee Benefit Plans Expert Panel. We are pleased to appear before the U.S. Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans (Advisory Council) on behalf of the AICPA.

We commend the Advisory Council for holding this hearing to identify what actions the Secretary of Labor may take with respect to the current Employee Retirement Income Security Act of 1974 (ERISA) audit requirements and the financial reporting model to enhance participant protection. Because there have been many significant changes in the employee benefit plan environment, financial reporting, and the auditing profession since ERISA became law over 35 years ago, we believe it is helpful, and perhaps even necessary, to revisit ERISA plan reporting and audit requirements.

Central to the accounting profession's mission is to ensure meaningful and reliable financial information for users of financial statements. In doing so, it is important to consider the financial information needs of the users, and to evaluate the cost of preparing and auditing the financial statements as well as the benefits.

The AICPA has a long history of making enhancements to financial reporting and auditing standards for employee benefit plans, and making recommendations to Congress, the Department and the Advisory Council on improving financial reporting and audit requirements. The AICPA's Employee Benefit Plans Expert Panel regularly monitors employee benefit plan financial reporting and audit issues. The AICPA annually revises the audit and accounting guide used by independent auditors of ERISA plans as well as plan management, and makes recommendations to the Financial Accounting Standards Board (FASB) on improvements to plan financial reporting standards.

We have previously testified before the Advisory Council and Congress on ERISA reporting and audit issues including the limited scope audit exemption in ERISA, auditing hard-to-value assets, stable value investments, and audits of health and welfare plans. We have also communicated with the Department on financial reporting and audit issues including the application of the limited scope audit exemption related to alternative investments.

Our comments and recommendations today will focus primarily on the following key areas we believe need to be addressed:

- Limited scope audit exemption in ERISA section 103(a)(3)(C)
- Section 403(b) plan reporting and audit requirements
- Health and welfare plan reporting and audit requirements

As we will discuss later, we believe that many of our recommendations in these areas can be implemented by regulation, interpretation or guidance under the existing regulatory authority granted the Secretary under ERISA.

We also will address other matters on which the Advisory Council requested comments, including:

- Plan-level versus individual participant account-level assurance for defined contribution plans
- Audit of Form 5500 and related schedules
- Financial reporting models
- Auditing standards
- Audit reports/piecemeal opinions
- Attestation standards
- Compliance with laws and regulations, plan operations and governance
- Audit quality initiatives

As you can see, the issues and recommendations we will discuss today cover a very broad range of important financial reporting and audit issues affecting ERISA employee benefit plans. Because of the limited time we have today to discuss our views and recommendations with the Advisory Council, we recommend the Secretary and/or the Advisory Council establish a special joint task force with the accounting profession to further consider these issues, recommendations and other alternatives.

Changes in Plan Environment since the Enactment of ERISA

Before we discuss our specific comments and recommendations, it is important to understand the major changes that have occurred in the employee benefit plan environment. When ERISA was signed into law in 1974, employers offered mostly defined benefit pension plans and health and welfare plans whereby participants received benefits from employer funded plan assets. Participants typically did not have their own money at stake, as is the case of cash or deferred arrangements. The popular 401(k) plan was not introduced until 1980.

In 1974, the typical investment portfolio of a defined benefit pension plan consisted primarily of traditional investments such as U.S. government securities, publicly traded stock, and corporate bonds whose current value was easily determinable by reviewing the financial pages of the daily newspaper. Plan trustees and custodians could verify the value of such holdings with a high degree of confidence. In addition, the trustee or custodian physically held these investments in safekeeping.

Over the past 35 years the benefit plan environment has changed dramatically. The majority of plans offered to employees today are defined contribution 401(k) plans, funded by participant and/or employer contributions. In these plans, a separate account is maintained for each participant. Participants direct the selection of investments in their account and bear the investment risk of their individual account due to adverse market conditions. 401(k) plans provide for participant direction whereby participants choose which funds offered by the plan in which they will invest. Some plans are self-directed, whereby participants can choose to invest their money in a wide variety of investments, typically through a brokerage account.

Defined benefit pension plans increasingly have shifted assets from traditional investments into higher risk “hard-to-value” investments in an effort to diversify their portfolios and earn higher returns. These investments include private investment funds, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, and nonmarketable derivatives. Hard-to-value investments are not readily marketable and so their values are not listed on national exchanges or over-the-counter markets, nor are quoted market prices available from financial sources.

Further, many investments are no longer “physically held” by trustees or custodians because there are sub-custodians holding the plan’s investments in separate or omnibus accounts.

These changes have added complexity to employee benefit plan audits. We believe that changes are needed to the current reporting and audit requirements to adequately address these changes in the plan environment.

#### Limited scope audit exemption in ERISA section 103(a)(3)(C)

One important area where we believe changes are necessary is the limited scope audit exemption in ERISA section 103(a) (3) (C)<sup>1</sup>. Such an exemption is unique to ERISA employee benefit plans; it does not exist in any other industry. The AICPA has been on record since 1978 supporting repeal of the limited scope audit exemption, and in 1998 the AICPA supported the Administration and the U.S. Government Accountability Office (GAO) in their legislative efforts to repeal limited scope audits. We also communicated our concerns regarding limited scope audits in a letter to Assistant Secretary Bradford P. Campbell dated April 19, 2007, which is attached to our testimony.

ERISA's limited scope audit exemption allows the plan administrator to instruct the independent auditor not to perform any auditing procedures with respect to investment information prepared and certified by a qualified institution which acts as trustee or custodian of plan investments or their agent<sup>2</sup>. The limited scope exemption applies only to the investment information certified by the trustee or custodian, and does not extend to participant data, contributions, benefit payments, or other information whether or not it is certified by the trustee or custodian. Additionally, in a limited scope audit, the auditor has no responsibility to obtain an understanding of the controls maintained by the certifying institution over assets held and investment transactions executed by the institution which was one of the primary reasons for allowing the limited scope exemption.

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<sup>1</sup> The limited-scope audit exemption is implemented by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA.

<sup>2</sup> In a letter dated May 17, 2002 from John J. Canary, Chief, Division of Coverage, Reporting and Disclosure, Office of Regulations and Interpretations to Mr. Richard M. Steinberg, Chair, AICPA Employee Benefit Plans Expert Panel, the Department noted the following:

"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. [.....] some plan administrators may assume that information provided in connection with limited scope audit statements necessarily represents a certification by the financial institution of the current value of the plan's assets. In addition to determining whether the conditions for limiting the scope of an accountant's examination have been satisfied, administrators should take steps to make sure they understand the nature and scope of the certification the institution has provided before concluding that the certified information may be used to satisfy the administrator's obligation to report the current value of the assets on the plan's annual report (Form 5500 Series)."

Many times there is an “expectation gap” between what is covered by the certification and what the plan administrator thinks is covered by the certification. The trustee or custodian is only required to certify as to whether the information on the statement is complete and accurate based on information obtained from their ordinary business records. Therefore, a certification does not necessarily mean that the values actually represent current or fair value as of the plan’s year end as required by ERISA and generally accepted accounting principles (GAAP). The typical custodial service provided by trustees or custodians includes providing values that are based on the best available information at the time of the report. If the plan is invested solely in assets with readily determinable fair values, such as mutual funds or marketable securities, the trustee or custodian typically obtains fair values from nationally recognized pricing services, and those values will be relatively easy to verify. However, in cases where the plan invests in assets without readily determinable fair values, and where the trustee or custodian may have been hired only to provide custodial services, the values in the trust report typically will be a pass-through of the values provided by another entity which may or may not be fair value (for example, the fund company or limited partnership for commingled funds, 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 of the report, which may or may not be fair value or the fair value as of the plan’s year end. If the information in the certification does not reflect current value or fair value and the plan uses this information in its Form 5500 and financial statements, the plan’s Form 5500 and financial statements may be incorrect. To obtain proper fair values for alternative investments, the plan may need to contract for valuation services in addition to the custodial services provided, verify the accuracy and validity of the valuation source, or perform its own valuation testing.

When the limited scope audit exemption is elected by the plan administrator, the auditor generally will conclude this is a significant limitation on the scope of the audit and the auditor will not express an opinion on the overall fairness of the financial statement presentation. Therefore participants lose the inherent benefit of an independent auditor’s opinion on the plan’s financial statements. The Department estimates that limited scope audits account for 60-70 percent of the 80,000 ERISA audits performed every year. And those numbers likely will

increase substantially as 403(b) plan audits are performed for the first time this year, as I will discuss later.

As noted previously, when ERISA was enacted, most plan investment portfolios consisted primarily of assets for which plan custodians could verify the value with a high degree of confidence, making the certification by the trustee or custodian reliable. As plans have increasingly invested in alternative investments, many plan sponsors have continued to blindly elect the limited scope audit exemption without knowing whether the information in the certification represents fair value. In such cases the certified investment valuation information may not meet the Department's Form 5500 filing requirements for reporting plan assets at current (fair) value as of the plan's year end. Based on this limited scope audit election, plan administrators have instructed auditors not to perform any audit procedures on the investment information which could be several months old (for example, as of the end of the prior calendar quarter) or was obtained from a source that had not performed adequate valuation procedures as of the plan's year end. Thus, the certified information may be inappropriately relied upon and used by plan administrators to prepare the plan's Form 5500 and the plan's financial statements.

We believe this situation is becoming more prevalent given the increase in alternative investments held by employee benefit plans and more trustees and custodians are performing "recordkeeping-only" services and not being hired by the plan to perform valuation services on the alternative investments. In addition, as more plans use investment managers to make investment decisions, the investment trustee and custodian are not directly involved with the purchase or sale of plan investments and thus may not maintain the information needed to make assessments of current value of investments held.

Determining the value of alternative investments, which can fluctuate substantially and may not have readily available market values, can be difficult. Valuation is subjective, often requires the assistance of third-party specialists, and may be complicated by limited transparency. Indeed, some certifications include disclaimers about the trustees or custodians' limited ability to affirm valuations of alternative investments, generally because year-end valuation information is not available or the information is not verifiable. Some even exclude certain information—such as

the valuation of investments—from the certification. In some instances, these certifications have caused plan administrators to obtain a full scope audit, as the certification cannot be relied upon. In other instances, the plan administrator continues to elect to have only a limited scope audit in error.

We understand there is concern that if the limited scope audit exemption is repealed it may increase the cost of audits. When ERISA was passed in 1974, significantly more audit work in the area of investments—likely at substantial cost—would have been required to perform a full scope audit instead of a limited scope audit. However today, because of changes in auditing standards since ERISA was enacted, much of the additional effort and cost to perform a full scope audit may be reduced due to the availability of service auditor reports covering the plan’s internal controls at third-party service organizations. These service auditor reports also may cover important ERISA compliance areas. Auditors are able to rely on the service auditor reports to significantly reduce their audit work for the plan. So in many cases the auditor will be able to perform a full scope audit and issue an opinion on the financial statements, rather than disclaiming an opinion, without a significant increase in cost to the plan.

Even if the limited scope audit exemption is not ultimately repealed, we believe improvements can and should be made under the Secretary’s existing regulatory authority that would address many of our concerns.

*AICPA Recommendations:*

- 1. The Secretary should seek legislative repeal of the limited scope audit exemption or, at a minimum, allow the election of the limited scope audit exemption only for assets whose current value is based on quoted prices in active markets for identical assets.*
- 2. The Secretary should ensure that plan administrators are aware of their fiduciary responsibilities for electing limited scope audits when the plan invests in alternative investments, and to ensure plan participants receive current and accurate information*

*about the value of alternative investments held by the plan as of the plan's most recent year end.*

- 3. The Secretary should issue guidance to plan administrators on the proper use of certifications in situations where the plan invests in alternative investments that are not valued at current value as of the plan's year end. This would include the plan administrator ensuring that those investments are excluded by the trustee or custodian from the certification, and thus would be subject to full scope audit procedures by the plan's independent auditor.*
- 4. The Secretary should provide guidance on what constitutes an acceptable certification, including the meaning of "complete and accurate" for a proper certification that meets the requirements of ERISA section 103(a) (3) (c) and 29 C.F.R. § 2520.103-8. There also should be clarification that only the information needed by the plan administrator is required to be certified and that the certifying financial institution should disclose which investments have not been fair valued as of the plan year end.*
- 5. The Secretary should clarify who is allowed to certify the investment information.*
- 6. The Secretary should require plans that elect the limited scope audit exemption to include the certifications with their Form 5500 filings, and the certifications should be subject to review by the Department.*

The AICPA previously communicated its recommendations on certification issues related to alternative investment information in an April 19, 2007 letter from Marilee Lau to Assistant Secretary Bradford P. Campbell. Marilee Lau also previously testified before the Advisory Council on July 15, 2008 on limited scope audits and hard-to-value assets (copies of the letter and testimony are attached).

The Advisory Council also asked witnesses to address whether the Secretary should allow for opinions that would be similar in nature to a piecemeal opinion. A piecemeal opinion is an opinion where the auditor expresses an adverse opinion or a disclaimer of opinion on the financial statements as a whole, but includes a supplementary unmodified opinion on one or

more specific elements, accounts or line items of a financial statement. Such an opinion is not permitted under generally accepted auditing standards (GAAS) as it tends to overshadow or contradict the adverse opinion or the disclaimer of opinion. The Secretary should not allow for piecemeal opinions. (See section on Auditor Reports/Piecemeal Opinions later in this testimony.)

### Section 403(b) Plan Reporting and Audit Requirements

In November 2007, the Department eliminated an exemption granted to section 403(b) plans from the annual Form 5500 reporting, disclosure and audit requirements under ERISA.<sup>3</sup> The removal of this exemption subjects ERISA-covered 403(b) plans to the same Form 5500 reporting and audit requirements as 401(k) plans effective with their 2009 plan year Form 5500 filings. ERISA section 103(a) (3) (A) requires the plan administrator to engage an Independent Qualified Public Accountant (IQPA) to audit the financial statements of a 403(b) plan using GAAS, and to prepare an opinion as to whether the financial statements (and any supplemental schedules required to be included in the annual report) are presented fairly in conformity with GAAP.

The Department issued DOL Field Assistance Bulletin (FAB) 2009-02, *Annual Reporting Requirements for 403(b) Plans*, and FAB 2010-01, *Annual Reporting and ERISA Coverage for 403(b) Plans*, to provide enforcement relief for plan administrators that make good faith efforts to transition to the new annual financial reporting requirements. DOL FAB 2009-02 allows the plan administrator to exclude certain pre-January 1, 2009 annuity contracts and custodial accounts for ERISA reporting purposes.

By law auditors cannot disregard incomplete financial statements because ERISA requires the audit reports to identify whether the financial statements are prepared in accordance with GAAP. Therefore if the plan administrator elects to exclude some or all of those contracts or accounts meeting the conditions of DOL FAB 2009-02 from the plan's financial statements or instructs the auditor not to perform procedures on certain or all pre-2009 contracts, or both, the auditor will need to consider the effect of the exclusions on the completeness of the GAAP financial

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<sup>3</sup> U.S. Department of Labor's Notice of Adoption of Revisions to Annual Return/Report Forms issued on November 16, 2007 eliminated the exemption granted to section 403(b) retirement plans from the annual Form 5500 reporting, disclosure and audit requirements under ERISA Part 1 of Subtitle B of Title I.

statement presentation and restrictions on the scope of the audit. The auditor may be faced with both a GAAP departure for failure to report on the plan as a whole and a scope limitation on the audit.

In many cases this could result in the independent auditor issuing a qualified, adverse, or disclaimer of opinion. As noted previously, when the auditor concludes there is a significant limitation on the scope of the audit and issues a disclaimer of opinion, the auditor is not expressing an opinion on the overall fairness of the financial statement presentation. Therefore participants lose the inherent benefit of an independent auditor's opinion on the plan's financial statements. And when an adverse opinion is issued, it means that they are materially misstated and, when considered as a whole, do not conform with GAAP. If the reasons that gave rise to the modification(s) in the auditor's opinion continue to exist, the modification(s) to the auditor's opinion would continue to be appropriate in subsequent years. A disclaimer of opinion provides no independent assurance as to whether the plan's financial statements are fairly presented.

Despite the best efforts of 403(b) plan administrators and vendors to establish proper accountability for plan assets, independent auditors may still need to modify their opinions. The Department recognizes this constraint and has said it will not reject a 403(b) plan Form 5500 filing on the basis of a modified audit report if the sole reason was because of the plan administrator's election of the Department's enforcement relief.

*AICPA Recommendations:*

- 7. The Secretary could allow 403(b) retirement plans that cannot prepare GAAP financial statements (because of missing contracts and accounts) to prepare their financial statements using a regulatory basis of accounting<sup>4</sup> and allow independent auditors to report on whether the financial statements are prepared appropriately on that basis. A regulatory basis of reporting would need to be established by an appropriate level of authority (such as by DOL regulatory rulemaking or formal interpretation) and provide a uniform standard for the presentation of financial statements (i.e. – the reporting basis*

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<sup>4</sup> The relevant audit literature for reporting on a regulatory basis is found in AU sections 411.08, 544.04 and 623.03-.04 of the AICPA Professional Standards.

*needs to be comprehensive and consistent). Independent auditors could give an opinion on whether the financial statements are prepared appropriately on this regulatory basis of reporting and would also indicate the financial statements are not prepared on a GAAP basis.*

8. *Alternatively, the Secretary could require plans to have an IQPA perform certain agreed-upon procedures<sup>5</sup> under AICPA Professional Standards to test specific elements or accounts in the financial statements and/or compliance matters that the Department believes provide participant protection.*

### Health and Welfare Plan Reporting and Audit Requirements

The AICPA previously testified in September 2004 before the ERISA Advisory Council Working Group on Health and Welfare Form 5500 Requirements (Working Group) about the value provided by the existing audit requirements for health and welfare plans (A copy of our testimony is attached). The AICPA observed that participants find little use for the Form 5500 or financial statements for health and welfare plans, and they provide no information regarding the plans' ability to pay benefits when due, because the plans are not required to be funded, nor are plan sponsors required to fund or maintain benefits (unless required under a collective bargaining agreement).

In a single-employer corporate-sponsored defined benefit health and welfare plan, the plan's financial statements may not necessarily be an indication of the future probability of the plan's ability to pay benefits because the corporate sponsor is responsible for the costs in excess of plan assets, including participant contributions and sponsor contributions previously made to the plan. The plan's financial statements may well show a deficit funding position when in fact the plan is financially healthy. Since the ultimate obligation to pay benefits rests with the corporate plan sponsor, it is the financial health of the plan sponsor, not the funded status of the plan itself, that determines the likelihood of participants receiving benefits they were promised. Thus, the financial statements of a single-employer corporate-sponsored plan, while reflecting plan

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<sup>5</sup> In an agreed-upon procedures engagement the users of the report (i.e. – the Department and plan sponsor) must agree to the procedures to be conducted by the independent accountant that the users believe are suitable. The users take responsibility for the adequacy of the procedures and the independent accountant does not express an opinion or negative assurance. Instead, the independent accountant's report is in the form of procedures and findings.

liabilities and obligations and contributions made by the plan sponsor and participants, may not be meaningful in assessing whether the plan has the ability to pay current and future benefits. Additionally, many single-employer defined benefit health and welfare plans do not have significant amounts of investments as with pension plans.

Another issue with the financial statements for single-employer defined benefit health and welfare benefit plans is that there is a disconnect between the reporting for financial statement purposes and Form 5500 purposes. Audited financial statements that are filed with the Form 5500 typically are prepared in accordance with GAAP. Many health and welfare plans have obligations (such as incurred but not reported claims, postretirement benefits, and postemployment benefits) that are required by GAAP to be recorded on the audited financial statements, but are not reported on the Form 5500. Consequently, there often are numerous and substantial dollar differences between amounts reported on the Form 5500 submitted to the Department and the audited financial statements that accompany the Form 5500 filing.

An audit of a health and welfare benefit plan typically requires a significant amount of time and resources. The audit procedures required in a health and welfare plan environment extend far beyond any that are required to be performed for a 401(k) plan or defined benefit pension plan. Because of the complex nature of and constant changes to the nation's medical delivery and insurance programs, auditing medical expenses incurred by a plan participant is a complicated process that requires specialized knowledge of various payment and accounting systems and medical information. It should be noted that in many situations there is an overlap of the claims testing performed in connection with an ERISA audit and that of a specialized "claims audit," contracted externally by the corporate sponsor.

Because of the complexities in auditing health and welfare plans, fees paid to independent auditors for those plan audits can be three to four times the amount of the audit fees for 401(k) plans, and have increased dramatically the past several years because of changes in health care system delivery and payment systems and the impact of HIPAA. Factors affecting the audit fee include plan size, type of benefits, number of outside service providers, quality of plan recordkeeping, and the plan sponsor's ability to prepare the financial statements. It is questionable as to whether the benefits of these audits outweigh their costs given the fact that, as discussed earlier, the financial statements of a single-employer corporate-sponsored plan may not

be fully meaningful in assessing whether the plan has the ability to pay current and future benefits.

*AICPA Recommendations:*

9. *The Secretary should evaluate whether the cost associated with the current financial reporting and audit requirements for single-employer defined benefit health and welfare plans effectively meet the needs of the Department, participant protection, and the needs of other potential users of plan financial statements.*

10. *We encourage the Secretary to consider having plan auditors perform agreed-upon procedures that could provide a more cost effective approach to providing plan participants with appropriate protections and provide the Department with any necessary information.*

We will now address other matters on which the Advisory Council requested comments.

Plan-level versus Individual Participant Account-level Assurance for Defined Contribution Plans

The Advisory Council has asked witnesses to address the value and purposes of an audit of a defined contribution plan at the plan level, rather than at the level of individual participant accounts.

In a financial statement audit at the plan level, one of the auditor's objectives is to obtain reasonable assurance—that is, a high but not absolute level of assurance—that material misstatements, whether caused by fraud or error, are detected. A plan level audit includes the auditor evaluating the plan's internal controls and the internal controls at outside recordkeepers, assessing the risks of misstatement, testing individual participant data and eligibility, participant and employer contributions, distributions, loans, forfeitures, and administrative expenses; testing plan investments for existence and valuation, identifying party-in-interest transactions and the possibility for prohibited transactions; and evaluating the plan's tax status.

Plan level financial statement audits may detect, for example, recordkeeping errors affecting a participant's account balance, an improper definition of compensation used to determine the employer matching contribution; participant distribution checks being improperly diverted to

unauthorized individuals; improper use of participant forfeitures made by a service provider; duplicate expenses paid; and other operational issues. It may also detect situations where plan investments have been improperly valued.

While audit procedures directed at the plan level do provide valuable protections to the individual plan participant, the audit is directed to expressing an opinion on the overall financial statements rather than the individual participant statements, which we understand may seem more relevant to a participant who is more concerned about whether his or her individual account balance is correct. As a practical matter, however, obtaining independent assurances at the individual participant account balance level is neither realistic nor economically feasible. Accordingly, we believe the Department should not establish new or different audit standards for defined contribution pension plans.

*AICPA Recommendation:*

*11. If the Secretary determines that assurance is necessary at the individual participant account -level, we recommend plans be required to have an IQPA perform certain agreed-upon procedures in accordance with the AICPA's Professional Standards (as an alternative or in addition to the plan-level audit) to test specific individual participant accounts and/or compliance matters that the Secretary believes provide participant protection.*

#### Audit of Form 5500 and Related Schedules

The Advisory Council has asked witnesses to address whether the Secretary should require auditors to audit the Form 5500 and its required schedules. Generally, the financial amounts reported on Schedule H of the Form 5500 are reported on the same basis as the amounts reported in GAAP financial statements. The Form 5500 also includes certain schedules that are not required under GAAP. GAAP financial statements also must include additional explanatory notes that are not required in the Form 5500. The notes to the financial statements must also provide an explanation of differences between the information contained in the financial statements and the amounts reported on schedule H in the Form 5500. While the auditor's current responsibility for the Form 5500 does not extend beyond the information in the auditor's report, GAAS requires the auditor to read the other information in the Form 5500 and consider

whether such information is materially consistent with the audited financial statements. Further, the auditor is required to express an opinion as to whether the supplemental schedules are fairly stated in all material respects in relation to the financial statements taken as a whole. As such, we believe that an audit of the Form 5500 and related schedules would not provide any additional participant protection.

### Financial Reporting Models

The Advisory Council has asked witnesses to address to what extent the Secretary should interpret the phrase “generally accepted accounting principles” to include one or more Other Comprehensive Bases of Accounting (in addition to including GAAP, as promulgated by FASB). ERISA requires the preparation of financial statements and schedules that then must be audited by an IQPA. ERISA does not require that plan financial statements be prepared in accordance with GAAP, so it is not necessary for the Secretary to interpret ERISA in this matter. ERISA already permits plans to, and many currently do, prepare their financial statements using an Other Comprehensive Basis of Accounting. As discussed previously, there are situations (i.e.- certain 403(b) plan audits) where we believe regulatory reporting models may be appropriate.

GAAP financial statements provide information to users about the plan’s financial status and activity. The primary objective of GAAP financial statements is to provide information that is useful in assessing the plan’s present and future ability to pay benefits. Participant protection is dependent upon how the users (trustees, fiduciaries, DOL, PBGC, IRS, and participants, as well as labor and management in multiemployer plans), use the information in fulfilling their responsibilities and in making decisions.

Since 1973, the FASB has been the designated organization in the private sector for establishing standards of financial accounting, or GAAP. Those standards govern the preparation of financial statements. The FASB is part of a structure that is independent of all other business and professional organizations. The FASB follows an extensive “due process” that is open to public observation and participation. The FASB is required to issue for public comment all proposed amendments to its authoritative standards, and provides interpretations and implementation guidance as needed.

Since the FASB's inception, the AICPA has participated in developing accounting standards for employee benefit plans and has a record of recommending improvements to financial accounting, reporting and disclosure for employee benefit plans.

FASB Accounting Standards Codification™ (ASC) is the sole source of GAAP for employee benefit plans. When the ASC became effective in September 2009, it codified various existing standards and guidance issued by the FASB and the AICPA, including some information from the AICPA Audit and Accounting Guide, *Employee Benefit Plans* (the Guide). GAAP continues to evolve as new issues arise, such as the accounting for plan loans and fair value measurements. And the AICPA still plays a role in providing nonauthoritative guidance to plans on complex issues not addressed by the FASB through the Guide, AICPA Technical Practice Aids, and the annual AICPA Audit Risk Alert, *Employee Benefit Plans Industry Developments*.

We believe the Secretary should not establish a new financial reporting model for ERISA plans (with the exception of 403(b) retirement plans that cannot prepare GAAP financial statements because of missing contracts and accounts as previously discussed).

### Auditing Standards

ERISA also contains a requirement for annual audits of plan financial statements by an IQPA. Generally, plans with 100 or more participants are subject to the audit requirement. The auditor's objective as established by ERISA is to express his or her professional opinion on whether the plan's financial statements are fairly presented in conformity with GAAP in all material respects and that ERISA-required supplemental schedules are fairly stated in all material respects in relation to the basic financial statements taken as a whole. ERISA also states that the audit is to be performed in accordance with generally accepted auditing standards.

We believe generally accepted auditing standards are the appropriate model under which to conduct engagements required by ERISA. An audit provides independent, third party opinion to participants, those responsible for the plan's management, and other financial statement users that the plan's financial statements provide reliable information to assess the plan's present and future ability to pay benefits.

Generally Accepted Auditing Standards are established by AICPA Auditing Standards Board (ASB) and are the professional standards followed by plan auditors to audit and opine on financial statements. A financial statement audit does not ensure that the plan's operation is in compliance with all laws and regulations. A GAAS audit of an ERISA plan's financial statement includes assessing the risks of misstatement; evaluating internal controls over financial reporting; and testing the existence and value of plan investments, testing participant data and eligibility, participant and employer contributions, distributions, loans, forfeitures, administrative expenses, etc.; identifying "party-in-interest" transactions and the possibility for prohibited transactions; and evaluating the plan's tax status.

With the rapid pace of change in today's audit environment, it already is difficult for auditors to keep up to date on a single set of audit standards. Adding a new set of standards could lead to significant confusion for plan auditors, thereby creating a higher risk of error in meeting the standards.

Over the years, the Auditing Standards Board (ASB) has issued many new auditing standards to strengthen the audit process, some of which are detailed in Appendix A of our testimony. Other government agencies, such as the Government Accountability Office (GAO) accepts GAAS as a starting point because they recognize the high quality of those standards. We believe the Secretary should continue to require GAAS standards as established by the audit profession as the appropriate audit standards for performing financial statement audits of ERISA plans.

#### Audit Reports/Piecemeal Opinions

An audit enables plan participants and others to use financial statements with confidence. Although an audit does not guarantee financial statement accuracy, an audit is designed and performed in order for the auditor to obtain reasonable assurance (a high but not absolute level of assurance) that the financial statements are in conformity with GAAP. An audit enhances users' confidence that financial statements do not contain material misstatements because the auditor is an independent, objective expert who is knowledgeable about the entity's business and financial reporting requirements.

Once an auditor has completed his or her extensive testing and determined that the plan's financial statements were prepared in accordance with GAAP, an opinion is offered on the reliability of the numbers as a whole. There are several types of opinions an auditor can provide.

If the auditors have no disagreement with the plan sponsor's accounting procedures and resulting statements, they will issue an unqualified or clean opinion. This is not a "stamp of approval" since an audit cannot be a 100 percent guarantee, but rather it is an objective, independent opinion that the financial statements are reliable and have been prepared in accordance with GAAP.

In some circumstances, a fourth paragraph is added to the clean opinion to indicate an auditor's concern. A fourth paragraph is a clean opinion with "emphasis added," to call attention to the fact that plan's management has changed accounting methods since the previous year, that "uncertainties" exist that cannot be accounted for, or that, in the auditor's opinion, the plan's financial health is in serious jeopardy.

A qualified opinion indicates that the auditor disagrees with the accounting method used or the level or type of disclosure in the financial statements. While the auditor's opinion is on the whole acceptable, the auditor feels obliged to draw attention to a part of the statements where the plan has not followed GAAP.

An adverse opinion is the most serious opinion an auditor can offer – it indicates that a plan's accounting is misleading and does not fairly reflect the plan's financial condition and or activities. The difference between a qualified opinion and an adverse opinion is a matter of professional judgment on the part of the auditor depending on the extent and magnitude of the misstatements to the financial statements as a whole.

A disclaimer of an opinion indicates that the auditor has not been able to obtain sufficient evidence to form an opinion on the financial statements as a whole. However, even when an auditor disclaims an opinion on the overall financial statements, the auditor still has an obligation to disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles. Therefore, in a limited scope, if the portion of the plan's assets or liabilities or activities that are subject to audit (usually everything except the

assets scoped out that are subject to the certification) are found to be materially misstated or not properly disclosed in accordance with GAAP, the auditor is required to include that fact in his or her report.

This obligation should not be confused with a piecemeal opinion, which is explicitly prohibited by generally accepted auditing standards. A piecemeal opinion is the complement of a qualified opinion. A qualified opinion gives an opinion on the financial statements as a whole and makes exceptions for certain items; whereas a piecemeal opinion disclaims or is adverse on the financial statements as a whole but gives an opinion on certain items. In the past, piecemeal opinions were not uncommon, but they presented so many problems and were so confusing that the profession, with the encouragement of regulators, prohibited their issuance.

A piecemeal opinion would be confusing to plan participants because it would include language that contradicts or may overshadow a disclaimer of opinion or adverse opinion. A piecemeal opinion takes specific items out of context of the financial statements as a whole and implies a greater degree of precision about those items under conditions that usually entail a lesser degree of certainty. When all these deficiencies are balanced against the limited usefulness of piecemeal opinions, and given the obligation to disclose a material misstatement anyway, the profession was well advised to abandon them.

### Attestation Standards

The AICPA Attestation Standards apply whenever an independent accountant is engaged to report on a subject matter—or an assertion about the subject matter—for which another party is responsible (for example, the effectiveness of a company's internal control over financial reporting or compliance with laws and regulations.) Under the Attestation Standards the independent accountant can perform three levels of engagements.

- In an attest engagement designed to provide a high level of assurance (referred to as an *examination*), the practitioner's objective is to accumulate sufficient evidence to restrict attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report.
- In an attest engagement designed to provide a moderate level of assurance (referred to as a *review*), the objective is to accumulate sufficient evidence to restrict attestation risk to a

moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures).

- In an *agreed-upon procedures* engagement the independent accountant issues a report of findings based on specific procedures performed on subject matter.

The key factors in an attestation engagement are the subject matter (the topic to which the engagement or that which is being tested pertains); the responsible party (the individual(s) accountable for the subject matter); and the evaluation criteria (the specific standards or benchmarks chosen by the client or responsible party to evaluate the subject matter).

As discussed below, these Attestation Standards may be used by independent accountants to test compliance with laws and regulations, plan operations, and governance matters as may be identified and required by the Secretary.

#### Compliance with Laws and Regulations, Plan Operations and Governance

The Advisory Council asked witnesses to address whether the independent auditor should be engaged by a plan administrator to review or audit the plan's compliance with laws and regulations, or any plan operations or governance. Auditors can test compliance with laws and regulations, or any plan operations or governance, but any such engagement should be separate from the financial statement audit. In such an engagement, the auditor would follow the AICPA's Attestation Standards. In an attestation engagement, the plan administrator must make assertions about its compliance with laws and regulations and those assertions must be objective and consistently measurable. It is also important to note that independent auditors cannot make legal determinations or judgments. The Secretary would need to implement regulations to require such compliance attestation engagements. In doing so, it is important to consider the cost of testing compliance as well as the benefits.

#### Audit Quality Initiatives

The AICPA recognizes the importance of ERISA audit quality and over the years has taken a number of steps to address the issue of assisting auditors in improving audit quality. These steps include revising and making annual conforming changes to the AICPA audit and accounting guide; preparing an annual audit risk alert for employee benefit plan audits; sponsoring two annual employee benefit plan conferences; developing tools and resources such as checklists, illustrative financial statements, technical practice aids, an employee benefit plans accounting trends and techniques book; and offering numerous continuing education opportunities.

In 2004 the AICPA established the Employee Benefit Plan Audit Quality Center (the Center). The Center currently has over 1,900 CPA firm members that audit over an estimated 75% of all ERISA plans. Member firms demonstrate their commitment to audit quality by voluntarily joining the Center and agreeing to adhere to the membership requirements. The Center membership requirements are listed in Appendix B of our testimony.

The Center's primary purpose is to promote the quality of employee benefit plan audits. To meet this goal, the Center has created a community of firms that demonstrate a commitment to employee benefit plan audit quality; serves as a comprehensive resource provider for member firms; provides information about the Center's activities to other employee benefit plan stakeholders; and raises awareness about the importance of employee benefit plan audits

The Center offers resources to enhance the quality of audits, and provides a Center Web site, [www.aicpa.org/ebpaqc](http://www.aicpa.org/ebpaqc), dedicated to the latest developments in employee benefit plan audits.

The Center also provides information to help educate plan sponsors, trustees, and other stakeholders about the importance of quality audits, how to select a plan auditor, how to contact the Department, and other important issues that affect audit quality.

An indicator of the Center's success comes from the Employee Benefit Security Administration's Office of the Chief Accountant which finds through its audit quality monitoring program a difference between the quality of audits performed by Center firms and those audits performed by nonmembers. Reviews performed by the EBSA's Office of the Chief Accountant also show fewer audit deficiencies in audits performed by Center member firms. And where deficiencies are noted, they tend to be less severe for Center member firms.

The AICPA also requires all AICPA members active in the practice of public accounting to be associated with a firm that participates in an AICPA-approved practice-monitoring program. Firms (and individuals) enrolled in the AICPA Peer Review Program are required to have a peer review, once every three years, of their accounting and auditing practice related to non-Securities and Exchange Commission (SEC) issuers. The peer review is conducted by an independent evaluator, known as a peer reviewer. The AICPA oversees the program, and the review is administered by an entity approved by the AICPA to perform that role. The peer review helps to monitor a CPA firm's accounting and auditing practice (practice monitoring). The goal of the practice monitoring, and the program itself, is to promote quality in the accounting and auditing services provided by the AICPA members and their CPA firms. This goal serves the public interest and enhances the significance of AICPA membership.

*AICPA Recommendations:*

*12. The Secretary should require all IPQA firms that perform ERISA audits to participate in a practice-monitoring (peer review) program. We believe the AICPA's practice monitoring program should be acceptable to the Secretary.*

*13. The Secretary should require all IQPA firms that perform ERISA audits to meet additional minimum qualification requirements such as those established for EBPAQC membership.*

The Advisory Council also asked witnesses to comment on the current enforcement regime for deficient annual reports, and whether there should be any changes to the role and authority of the Department's enforcement mechanisms and penalty structures as they relate to plan auditors. We believe the Department should work collaboratively with, and actively participate in, the efforts of the EBPAQC to enhance the quality of financial statement audits of ERISA plans, and to develop strategies for improving audit quality. The Department should also continue to use the enforcement program of the AICPA's professional ethics division (through its referral program) which has dedicated resources and the expertise necessary to evaluate and address performance issues. The ethics division has developed provisions that allow it to share its findings with the EBSA Office of Chief Accountant. We are ready to investigate any referrals that the Department makes and would be pleased to work with the Department to explore improvements and to

strengthen the referral and resulting investigative process. The individual State Boards of Accountancy are responsible for licensing CPAs who practice public accounting and for disciplining CPAs where appropriate, and we encourage the Department to work with the State Boards of Accountancy to review the current referral processes and to suggest improvements if they are needed as well.

This concludes our prepared remarks. To summarize, we believe that many of our recommendations can enhance participant protection and can be implemented by regulation, interpretation or guidance under the existing regulatory authority granted the Secretary under ERISA. We believe the Secretary should not develop a new financial reporting model different from GAAP (except for the limited situation where section 403(b) retirement plans will be unable, in the foreseeable future, to prepare GAAP financial statements because of missing contracts and accounts), the Secretary should not establish different auditing standards or interpret generally accepted auditing standards for ERISA plan audits, and the Secretary should not have new enforcement authority over plan auditors.

Again, thank you for the opportunity to present our views and recommendations. We stand ready to assist the Advisory Council and the Secretary with providing appropriate protections to participants.

We will now be pleased to answer any questions you may have.

\* \* \* \* \*

#### Appendices:

- Appendix A- AICPA Auditing Standards Issued to Strengthen the Audit Process
- Appendix B- Membership Requirements of the AICPA Employee Benefit Plan Audit Quality Center (EBPAQC)

#### Attachments:

- AICPA Audit and Accounting Guide, Employee Benefit Plans (March 1, 2010 edition)

- April 19, 2007, letter to Assistant Secretary Bradford P. Campbell on certification of alternative investments in on limited scope audits.
- September 22, 2004, testimony of Alice Wunderlich, member of the AICPA Employee Benefit Plans Expert Panel, before the ERISA Advisory Council Working Group on Form 5500 Health and Welfare Plan Audits.
- July 15, 2008, testimony of Marilee Lau, chair of the AICPA EBPAQC Executive Committee, before the ERISA Advisory Council Working Group on Hard-to-Value Assets/Target Date Funds
- September 16, 2009, testimony of Michele Weldon, chair of the AICPA Employee Benefit Plans Expert Panel, before the ERISA Advisory Council on the complexities and challenges in valuing and reporting stable value investments.

## APPENDIX A

### STATEMENT OF MARILEE LAU, CPA, AND MICHELE WELDON, CPA ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

#### AICPA Auditing Standards Issued to Strengthen Audit Process:

Over the years, the AICPA Auditing Standards Board (ASB) has issued many new auditing standards to strengthen the audit process and provide even greater assurance to financial statement users.

- *Fraud:* In 2002 the ASB issued SAS No. 99, which requires the auditor to (1) gather information needed to identify risks of material misstatement due to fraud, (2) assess these risks after taking into account an evaluation of the entity's programs and controls and (3) respond to the results.
- *Risk Assessment:* In 2006 the ASB issued what are commonly referred to as the "risk assessment standards" (SAS Nos. 104 through 111). The primary objective of these standards was to enhance auditors' application of the audit risk model by requiring auditors to obtain a more in-depth understanding of an entity in order to better identify risks of material misstatement of financial statements. This, in turn, should lead to an improved linkage between assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.
- *Audit Documentation:* In 2005, the ASB issued SAS No. 103, which requires the auditor, when preparing audit documentation, to consider the needs of an experienced auditor having no previous connection with the audit, to understand the procedures performed, evidence obtained, and specific conclusions reached. It also provides enhanced guidance concerning audit areas that should be documented and the retention of audit documentation. Additionally, it requires auditors to document audit evidence that is contradictory or inconsistent with the final conclusions and how the auditor addressed the contradiction or inconsistency.
- *Auditor Communications:* In 2006 the ASB issued SAS No. 112, which was replaced by SAS No. 115 in 2008; SAS No. 115 requires that auditors evaluate identified internal control deficiencies that arise out of the financial statement audit as to whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses. They also are required to communicate, in writing, to management and those charged with governance any significant deficiencies and material weaknesses identified in the audit. In 2006, the ASB also issued SAS No. 114, which requires the auditor to make certain communications with "those charged with governance" of an entity (the person or persons responsible for the strategic direction of the entity and the obligations relative to the accountability of such entity, including oversight of the financial reporting process).

- *Service Auditor's Reports:* In April 1992, the ASB issued SAS 70, which addresses how an auditor may use a service auditor's report to assess the internal controls at a third party service provider. Given the nature of the employee benefit plan environment and the heavy use of third party service providers, this standard has been very useful in employee benefit plan audits.
- *Reporting on Controls at a Service Organization:* In 2010 the ASB issued SSAE No. 16, which revises and defines the standards an auditor must employ in order to assess the contracted internal controls of a service organization. These requirements used to be detailed in SAS No. 70.

## APPENDIX B

### STATEMENT OF MARILEE LAU, CPA, AND MICHELE WELDON, CPA ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

#### AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) Membership Requirements

To be eligible to be a member of the Employee Benefit Plan Audit Quality Center, a firm must:

- Designate an audit partner to have firm-wide responsibility for the quality of the firms ERISA employee benefit plan audit practice.
- Have all audit partners of the firm residing in the United States and eligible for AICPA membership be members of the AICPA.
- Establish a program to ensure that all ERISA employee benefit plan audit engagement personnel possess current knowledge, appropriate to their level of involvement in the engagement, of applicable professional standards, rules and regulations for ERISA employee benefit plan audits. Such knowledge may be obtained from on-the-job training or training courses or both. For an individual signing audit opinions and an individual managing ERISA employee benefit plan audit engagements, the individual must complete a minimum of 8 hours of employee benefit plan-specific continuing professional education (CPE) within the three year period (or within the firm's or individual's most recent CPE period ending within the three year period) prior to signing an ERISA employee benefit plan audit opinion or managing an ERISA employee benefit plan audit engagement. Thereafter, the individual must have a minimum of 8 hours of employee benefit plan-specific CPE every three years (or within the firm's or individual's CPE period covering a three year period) where an individual continues in this capacity for ERISA employee benefit plan audits.
- Establish policies and procedures specific to the firms ERISA employee benefit plan audit practice to comply with the applicable professional standards and Center membership requirements. These policies and procedures must be documented and appropriately communicated.
- In addition to meeting the quality control standards requirement for monitoring, establish annual internal inspection procedures that include a review of the firms ERISA employee benefit plan audit practice by individuals possessing current experience and knowledge of the accounting and auditing practices specific to ERISA employee benefit plan audits. The engagements inspected should be representative of the firms ERISA employee benefit plan practice considering the number and different types of plan audits (e.g.- defined benefit, defined contribution, health and welfare, multiemployer, ESOPs, limited and full scope) and the various locations at which those audits are performed. The internal inspection should include reviewing the firm's compliance with the Center membership requirements. The internal inspection reports specific to the ERISA engagements should be made available to the firms peer reviewer.
- Make publicly available information about its most recently accepted peer review as determined by the Executive Committee.

- Have its ERISA employee benefit plan audits selected as part of the firms peer review reviewed by individuals employed by a Center member firm.
- Periodically file with the Center information about the firm and its ERISA employee benefit plan audit practice, and agree to make such information available for public inspection, as determined by the Executive Committee.
- Pay dues as established by the Executive Committee.
- Comply with additional requirements as may be established by the Executive Committee and approved by the AICPA Board of Directors.