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New Rules for "Limited Scope" ERISA Audits Aimed at Improving Consistency and Quality

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New rules regarding ERISA plan audits are designed to bring consistency to audit methods and address concerns about audit quality. While compliance falls largely on auditors, plan sponsors will have new responsibilities for certain matters and will notice important changes in the auditor's report on financial statements starting as early as 2021.

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New rules that will add significant detail and transparency to audit reports for retirement plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) impose new requirements on plan sponsors, particularly those who instruct their auditors to perform what until now has been known as a "limited scope audit." Most of the responsibility to comply with the new rules, however, will rest with the independent auditors who perform the audits. As a result, the retirement plan audit reports that plan sponsors receive from their accounting firms beginning as soon as 2021 will be noticeably longer and more detailed.

The new rules are designed to address concerns about audit quality that were expressed by the US Department of Labor (DOL) in 2015.

Background

The DOL in 2015 released a troubling report showing that 39 percent of audits performed on financial statements of employee benefit plans contained major deficiencies, putting $653 billion and 22.5 million plan participants and beneficiaries at risk. The number of plan participants and the amount of assets at risk had increased from previous assessments.

Specifically, most deficiencies were found in audit areas that are unique to employee benefit plans, such as eligibility, contributions, benefit payments, participant data, and party-in-interest/prohibited transactions. The DOL found that some auditors failed to comply with professional standards either because they did not possess the technical skills to perform employee benefit plan audits or they failed to utilize the available technical materials effectively.

The DOL study involved 400 audits performed by 232 accounting firms of all sizes. The study drew a strong correlation between audit quality and the number of ERISA audits the accounting firms performed annually.

Average deficiency rates ranged from 12 percent among firms performing 100 or more ERISA audits annually to approximately 70 percent among firms performing fewer than 25 ERISA audits annually.

New Rules Address Audit Quality

In an effort to address the DOL's findings and improve ERISA plan audit quality, the American Institute of Certified Public Accountants (AICPA) in 2019 released a new Statement on Auditing Standards—"SAS 136: Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA."

The most visible change in SAS 136 is in the audit report for ERISA plan financial statements. The audit report under SAS 136 will look significantly different, as the information presented will be re-organized, and the language will be clarified and expanded to more clearly express the auditor's opinion, and the basis for the opinion, on plan financial statements.

"Limited Scope Audits"

When ERISA plan sponsors engage auditors for a so-called limited scope audit, it means that the auditors need not perform any auditing procedures with respect to investment information prepared and certified by a bank or insurance company that acts as a trustee or custodian. Instead, the auditors focus their auditing procedures on participant-level data and participant counts.

Under current auditing standards, the audit report produced under a limited scope audit is a "disclaimer" audit opinion, which is acceptable by the DOL. SAS 136 still allows for a limited scope audit, but electing this type of audit is no longer considered a scope limitation.

The name of this type of audit has changed from a "limited scope audit" to an "ERISA Section 103(a)(3)(C)" audit. The audit opinion of an ERISA Section 103(a)(3)(C) audit will include information on the procedures performed on both certified and non-certified information.

Impact on Plan Sponsors

Probably the most significant point of the new rules is placing responsibility on plan sponsors for some matters that directly affect the plan. For example, the plan sponsor will be responsible for ensuring that the trustee or plan provider is a "qualified institution" when it comes to certifying that the plan-level investment transactions are complete and accurate. Currently, that is the auditor's responsibility.

The plan sponsor must provide to the auditor acknowledgements that the plan sponsor is responsible for:

- Determining whether a 103(a)(3)(C) audit is permissible and whether the certification meets ERISA requirements;

- Maintaining and providing a current plan document;
- Preparing and fairly presenting financial statements; and
- Providing a substantially completed (draft) Form 5500 to the auditor for the auditor's review prior to the date the physical audit begins.

Plan sponsors also will be responsible for understanding which investments and disclosures are subject to the qualified institution's certification of completeness and accuracy. Plan sponsors will need to acknowledge, in writing, that it has fulfilled all of the above responsibilities.

These rules take effect for plan years beginning after December 15, 2021, but can be early adopted. In other words, the plan audits performed during 2020—which will be for the 2019 plan year—will not be affected, and the auditor may further delay the new rules through 2021 (relating to the plan year 2020 audits). Notwithstanding this delay, it would be advisable for plan sponsors to talk to their plan custodians this year about what documentation they will provide to verify their status as a qualified institution and facilitate the new audit processes.

Change in 5500 Preparation Also Will Impact Plan Sponsors

It is important to note that auditors must review a substantially completed Form 5500 before the audit can be completed. This means that the plan sponsor will need to make sure that the form is available for this review sooner than may have been the case in earlier years, changing some of the procedures that have historically been in place for the plan.

Impact on Auditors

Auditors will bear responsibility for most of the significant effects of SAS 136. The impact of this responsibility will start before the engagement is even accepted, because SAS 136 imposes new requirements on the content of the auditor's engagement letter that lays out the details of the audit.

The new engagement letter language will include management's acknowledgment of its responsibilities for maintaining a current plan document, administering the plan, and providing the auditor with a substantially complete draft of the Form 5500 prior to completion of the audit. It also will include new acknowledgements related to management's responsibilities with respect to the investment certification when management elects to have an ERISA Section 103(a)(3)(C) audit and requires the auditor to inquire of management how it determined that the entity preparing and certifying the investment information is a qualified institution.

Generally, the audit opinion for an ERISA Section 103(a)(3)(C) audit will be longer, in part because SAS 136 replaces a modified opinion (typically a disclaimer opinion) previously used with limited scope audits with a new two-part opinion. This opinion must demonstrate whether:

- The information in the financial statements not covered by certification is presented fairly; and
- The investment information contained in the financial statements reconciles with, or is derived from, the information contained in the certification.

Other auditor responsibilities under the new SAS 136 rules require the auditor to:

- Read the current plan document and consider relevant plan provisions when designing and performing audit procedures;
- Identify which investment information is certified; and
- Follow detailed requirements for providing written communication to the plan sponsor about the results of the audit.

The new rules also reformat and change certain content requirements within the auditor's report.

"Reportable Findings"

The audit firm will be required to communicate "reportable findings" in writing to management and those charged with governance for any instance where the plan is in noncompliance with plan provisions or there is something incorrect that is serious enough to require communication to the plan committee or the sponsor's board of directors. Reportable findings must be communicated in writing under the new rules; verbal communication is not sufficient. This is similar to current rules in relation to issues that are considered to be internal control material weaknesses and significant deficiencies. Additionally, reportable findings must be ranked by level of severity.

Reportable findings are defined as one or more of the following:

- An identified instance of noncompliance or suspected noncompliance with laws or regulations;
- A finding arising from the audit that is, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process; or
- An indication of deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgement, are of sufficient importance to merit management's attention.

Considerations for Plan Sponsors

While most of the new requirements of SAS 136 fall on the shoulders of the plan's auditors, a plan sponsor must be aware of all the changes. Sponsors should question: What are your responsibilities? What are your committee's or your organization's board members' responsibilities? How will your new audit report look?

Sponsors should anticipate that they may be surprised at receiving written communications noting deficiencies in how the plan is operating. As noted, in the past auditors may have communicated deficiencies verbally in post-audit meetings, but now must put them in writing and rank them by severity. This may alarm management but, hopefully, will enable the company to more readily recognize when corrections and modified procedures are required.

Sponsors must prepare their organizations, particularly if they have received verbal warnings in the past from auditors about problems with the operations of the plan, for these new procedures and demands for operational quality. Now would be a good time for sponsors to anticipate what is needed and to make necessary changes. Moreover, the pre-audit and post-audit meetings with the audit firm in relation to the 2020 plan audit may be a good time to map out the changes to be made before the new rules are in place for future plan audits.

In Summary

Once SAS 136 is implemented, sponsors will see a significant change in the ERISA plan financial statement audit report. Specifically, the information presented will be reorganized and more detailed.

If a sponsor elects an ERISA Section 103(a)(3)(C) audit (formerly known as "limited scope audit"), new questions and procedures relating to the certification statement provided by the plan's asset custodian or trustee will need to be answered. This is a new responsibility for plan sponsors, so it is essential that they educate themselves ahead of time and prepare for what is needed. Auditors can help their clients in this process.

Sponsors may see expanded and more specific reportable findings from their auditor to management and individuals responsible for the plan's governance. If the auditor has verbally communicated concerns in the past about plan deficiencies, sponsors should do everything possible to address those issues before they turn up as reportable findings in the new audit report. ■