Full Scope vs. Limited Scope Audits in Retirement Plans

Agenda

- Conducting independent plan audits
  - Benefits
  - Requirements
- Department of Labor Self-Examination
- Comparison of Full Scope vs. Limited Scope Audits
- Findings of the DOL Report
- Recommendations

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Prior to founding the Multnomah Group in 2003, Erik served as a Vice President of Retirement Services and led the Portland, OR practice of a national retirement services firm. In that position Erik was a founding member of the firm's national Investment Committee and had oversight for business development in the western United States.

Erik is a member of the CFA Institute, the CFA Society of Portland, the CFA Society of Seattle, the American Society of Pension Professionals and Actuaries, the Portland Chapter of the Western Pension & Benefits Council, and the Society for Human Resource Management. Erik holds a B.B.A. from the University of Iowa.

Audit Requirements

- ERISA §104(a)(1) requires the administrator of an employee benefit plan subject to Part 1 of Title I of ERISA to file annual report with Secretary of Labor
  - Include Form 5500/Report of Employee Benefit Plan
- ERISA §103(a)(3)(A) requires the administrator or certain plans to engage an independent qualified public accountant to conduct a (full scope) examination in accordance with generally accepted auditing standards, and to perform tests considered necessary
  - Requires an accountant's opinion to be made a part of the annual report
- ERISA §103(a)(3)(C) provides option for limited scope audit for qualifying plans
  - Established with ERISA in 1974
  - Allows auditor to rely on investment information certified by banks or insurance carriers, based on belief that assets held by banks and insurance carriers are already subject to governmental audit and regulation
  - Does not extend to participant data, contributions, benefit payments

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Benefits of an Independent Plan Audit

- Provide assurance to plan participants that their records are being properly maintained
    - Financial statements have been examined
    - Sound plan operating processes
- Review the adequacy and efficacy of the plan's internal controls

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Department of Labor Self-Examination

- In 2010, DOL ERISA Advisory Council conducted a study on Employee Benefit Plan Auditing and Financial Reporting Models

- The study identified the following misunderstandings about the use of limited scope audits:
  - What is covered by a limited scope audit
  - What entities can offer asset certifications
  - Significance of the certifications with regard to asset valuation and the audit
  - Importance of a limited scope audit

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Limited Scope Audit in Current Environment

- Significant changes to the types of investment options utilized
  - Limited partnerships
  - Private equity funds
  - Hedge funds
- Many custodians hold these securities at the issuing value and only update values when provided additional data from the issuer, general partner, etc.
- Types of custodians and the environment for custody has changed
  - Qualified financial institutions have only electronic book entries to show they are holding plan assets
  - Information from these electronic entries may come directly from clearinghouses or from brokers and other non-qualified institutions

Comparing Full Scope Audits and Limited Scope Audits

Audit Aspects	Full Scope Audit	Limited Scope Audit
Provides auditor's opinion on plan's financial statements	Yes (unqualified, qualified, or adverse opinion)	No (disclaimer of opinion)
Auditor audits plan investments	Yes. Auditor tests for completeness and accuracy	No. Plan sponsor instructs auditor not to test investments (including the value of the investments and any income thereon) that are covered by the certification (including hard to value assets).
Requires addressing hard to value asset issues for financial reporting	Yes	Yes, except the auditor does not evaluate internal controls for certified investments and generally cannot evaluate whether the plan's financial statements overall are presented in accordance with GAAP due to the significance of the certified investment reported but not audited.

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Comparing Full Scope Audits and Limited Scope Audits (cont'd)

Audit Aspects	Full Scope Audit	Limited Scope Audit
Audit scope includes testing of participants records, contributions, benefit payments, internal controls over financial reporting, and overall presentation of financial statements	Yes	Yes, except the auditor does not evaluate internal controls for certified investments and generally cannot evaluate whether the plan's financial statements overall are presented in accordance with GAAP due to the significance of the certified investment reported but not audited.
Fraud evaluation	Auditor obtains reasonable, but not absolute, assurance that the financial statements are not materially misstated due to fraud. Not all fraud may be detected in an audit. A well-concealed or insignificant fraud my avoid detection.	Same as a full scope audit except the auditor does not test certified investments for possible fraud; thus any fraud with respect to certified investments, may avoid detection by the plan's auditor.
Audit identifies any internal control, compliance, or operational issues	Yes. Significant matters detected by the auditor are reported to those charged with plan governance.	Same as a full scope audit except that matters related to certified investments are not tested by the auditor.

Source: Department of Labor, Employee Benefit Plan Auditing and Financial Reporting Models (2010)

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Council Findings

- ERISA Advisory Council concluded that there was “a deficiency of specific material evidence of participant harm caused by limited scope audits and the concern for possible increased costs that could result from a full scope audit.”

- The council issued recommendations for the DOL to increase quality of limited scope audits being performed

- Shortly after, AICPA began using State of Financial Reporting Accounting Standards 157 (FAS 157) to provide more insight into assumptions used to determine asset values

Department of Labor Review

September 28, 2012 the *Employee Benefits Security Agency (EBSA) of the DOL issues a report, "Changes Are Still Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants.*

Key Findings:

- "…protections and assurances have decreased over time for participants and beneficiaries."
- The percentage of plans electing limited scope audits has grown from 46% to 70% over the last 15 years
- Reported value of assets excluded from plan audits has grown from $520 B to more than $3.3 T over the same time

Recommendations:

- Use existing authority to clarify and strengthen limited scope audit regulations
- Make better use of enforcement tools over independent qualified public accountants
- Improve procedures in audit quality reviews
- Complete a statistically valid review of employee benefit plan audit quality

Department of Labor Review

Historically, the highest risk for deficient audits was in audits performed by less experienced firms: generally those that perform less than 25 employee benefit audits per year. This group of firms historically produced more deficient audits than firms performing more plan audits per year.

- For FYs 2010 and 2011, EBSA spent 70% of its reviews on these firms; yet, these firms audited less than 25% of plan assets

Recommendations

1. Partner with a competent and practiced independent qualified public accountant *(Selecting an Auditor for Your Employee Benefit Plan www.dol.gov/ebsa/publications/slectinganauditor.html)*

2. Augment with independent SSAE 16 audit of asset custodian

3. Understand how all of the current values of assets are determined

4. Have the audit report reviewed with the governing fiduciary group

5. Determine which audit structure provides the necessary assurances to plan participants about the plan's health

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