

PLAN ADVISORY

Understanding Auditor Communications





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Introduction

The AICPA Employee Benefit Plan Audit Quality Center has prepared this advisory to assist you as a plan sponsor, plan administrator, trustee, audit committee, employee benefit plan committee, administrative committee, or investment committee in better understanding the various communications that may be initiated by your plan auditor.

This advisory discusses:

- An overview of auditor communications
- Auditor's communication with those charged with governance
- Engagement letters
- Management representation letters
- Communications about internal control matters identified in an audit
- Management letters and verbal communications
- How auditor communications can help you
- Where to obtain additional information about auditor communications

An Overview of Auditor Communications

Communications with your auditor come in various forms – many are required by professional standards. The communications can be made at any time throughout the audit: during the planning stage, during fieldwork, and many times after the auditor's report is issued. Some communications will be formalized in writing, while others will be verbal communications. The communications will address various issues such as the nature and parameters of the engagement, plan internal control matters, and audit findings and recommendations for improvement. The following sections provide information about the communications you may expect from your plan auditor.

Auditor's Communication With Those Charged With Governance

Auditors are required to make certain communications to "those charged with governance" – that is, the person(s) with responsibility for overseeing the strategic direction of the plan and obligations related to the accountability of the plan. The appropriate individual or group may vary depending on the matter to be communicated. For a single-employer employee benefit plan, persons charged with governance may include the audit committee of the plan sponsor or the appropriate group overseeing the financial reporting process of the plan, such as the employee benefit committee, administrative committee, plan administrator or responsible party. For a multiemployer plan, those charged with governance ordinarily will be the board of trustees. When the appropriate party

with whom to communicate is not clearly identifiable, your auditor may consult with plan management or others who are responsible for engaging the auditor, to identify the relevant person(s) within your plan's governance structure with whom he or she will communicate.

Persons charged with governance of your plan can expect to receive communications from your plan auditor – either verbal or written – at various stages during the audit process. The required and/or encouraged communications by the auditor to those charged with governance include information about the responsibilities of the auditor in relation to the financial statement audit, an overview of the scope and timing of the audit, and any matters that occur during the audit that would be relevant to the persons charged with governance in overseeing the financial reporting process.

Such communications will probably take place during all phases of the audit, as the communications should be performed on a sufficiently timely basis to enable those charged with governance to take appropriate action, when needed. Auditors are not required to make these communications in writing unless, in the auditor's professional judgment, verbal communication would not be adequate. However, professional standards do require that the communications be two-way (i.e., the persons charged with governance actively acknowledge receipt and understanding of the communication). As such, these communications also provide a means for the auditor to obtain information from those charged with governance of your plan that may be relevant to the audit. Following is a list of some of the possible topics that your auditor may want to discuss with persons charged with governance of your plan and the possible timing of such communications:

Beginning of the Audit (These communications may be addressed in the engagement letter – see the Engagement Letters section below):

- The auditor's responsibility under generally accepted auditing standards (GAAS)
- The planned scope and timing of the audit

During the Audit:

- Significant findings and issues from the audit
- Difficulties or disagreements with management and/or third party providers

End of the Audit:

- Significant findings and issues from the audit
- Any management letter comments (see the *Management Letters and Verbal Communications* section below)
- Communications about internal control related matters (see the *Communications About Internal Control Related Matters Identified in an Audit* section below)
- Uncorrected misstatements to the financial statements
- Material audit adjustments to the financial statements
- Significant issues that were discussed with management

Auditors are required to make communications to those charged with governance, even if they know that management is communicating the same information to them.

Engagement Letters

Engagement letters establish an understanding with the client about the scope of services to be performed

Typically, this understanding is obtained during the planning phase of the audit, before the auditor performs any significant audit procedures. It may need to be updated during the course of the audit if the scope of the audit changes. Following is a list of matters regarding plan management's responsibilities and the auditor's responsibilities that you can expect to see in the engagement letter (this list is not intended to be all-inclusive):

Management Is Responsible For:

- Understanding that the objective of the audit is the expression of an opinion on the financial statements.
- The plan's financial statements and the selection and application of the accounting policies.
- Establishing and maintaining effective internal control over financial reporting.
- Designing and implementing programs and controls to prevent and detect fraud.
- Identifying and ensuring that the plan complies with the laws and regulations applicable to its activities.

- Making all financial records and related information available to the auditor.
- Providing the auditor with a letter at the conclusion of the engagement that confirms certain representations made during the audit.
- Adjusting the financial statements to correct material misstatements and for affirming to the auditor in the management representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Auditor Is Responsible For:

- Conducting the audit in accordance with GAAS. For plans that file a Form 11-K with the Securities and Exchange Commission (SEC), that audit is also conducted in accordance with standards of the Public Company Accounting Oversight Board.
- Obtaining reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect

error or fraud that is immaterial to the financial statements.

- Obtaining an understanding of the plan and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify significant deficiencies or material weaknesses.
- Making communications to those charged with governance in accordance with generally accepted auditing standards.
- Detailing the estimated fees and billing arrangements.

In addition to the above items, the engagement letter may address the following benefit plan-specific items:

- Whether the engagement represents a full-scope or a limited-scope audit as allowed under the DOL rules and regulations.
- Management's responsibility for establishing an accounting and financial reporting process for determining fair value measurements.
- The auditor's responsibility with respect to any supplemental schedules required

by the DOL accompanying the basic financial statements.

- The auditor's responsibility with respect to consideration of the plan's qualification for tax-exempt status, with sufficient specificity to make clear that the audit does not contemplate an opinion on plan tax qualification.
- The auditor's responsibility with respect to information in the Annual Report on Form 5500.
- The auditor's responsibility with respect to reporting matters that come to the auditor's attention regarding lack of compliance with ERISA requirements, making it clear that the audit does not encompass procedures specifically directed at determining such compliance.
- Whether, due to the complex or subjective nature of the subject matter, the audit may require the special skills and knowledge of a specialist.
- The auditor's responsibility with respect to electronic filings.
- The effects of other regulations or laws, such as Sarbanes-Oxley Act of 2002, the Health Insurance Portability and Accountability Act of 1996 (HIPAA), and the Pension Protection Act of 2006.

- If applicable, the involvement of third party service providers or affiliates of the public accounting firm on the audit engagement.
- That the Department of Labor may request certain workpapers be made available pursuant to their authority by law or regulation.

Management Representation Letters

Your auditor will request certain written representations from plan management

For your plan audit, the written representations normally will be obtained from the plan administrator or other parties performing the plan's management function for all financial statements and periods covered by the auditor's report. The specific written representations your auditor will request depend on the circumstances of the engagement and the nature and basis of presentation of your plan's financial statements. If your auditor is performing an audit in accordance with GAAS, plan management can expect to be asked to make specific representations related to the following matters (this list is not intended to be all-inclusive).

Financial Statements:

- Management's acknowledgment of its responsibility for the fair presentation

in the financial statements of net assets available for plan benefits, changes in net assets available for plan benefits, statement of benefit obligations and statement of changes in benefit obligations in conformity with Generally Accepted Accounting Principles (GAAP).

- Management's belief that the financial statements are fairly presented in conformity with GAAP.

Completeness of Information:

- Availability of all financial records and related data.
- Completeness and availability of all minutes of meetings of plan committees, trustee or directors, and committees of directors.
- Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- Absence of unrecorded transactions.

Recognition, Measurement and Disclosure:

- Management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both

individually and in the aggregate, to the financial statements taken as a whole.

- Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.
- Knowledge of fraud or suspected fraud affecting the plan involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
- Knowledge of any allegations of fraud or suspected fraud affecting the plan received in communications from employees, former employees, regulators or others.
- Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- Information concerning related-party transactions and amounts receivable from or payable to related parties.
- Guarantees, whether written or verbal, under which the plan is contingently liable.
- Significant estimates and material concentrations known to management

that are required to be disclosed in accordance with applicable accounting standards.

- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- Unasserted claims or assessments that the plan's lawyer has advised are probable of assertion and must be disclosed in accordance with applicable accounting standards.
- Other liabilities and gain or loss contingencies that are required by applicable accounting standards to be accrued or disclosed.
- Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.
- Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events:

- Information concerning subsequent events.

Because the representation letter typically is tailored to include additional

representations specific to an entity's business or industry, your plan auditor may also ask for representations about the following:

- Whether financial circumstances are strained, with disclosure of management's intentions and the plan's ability to continue as a going concern.
- Whether the possibility exists that the value of specific significant long-lived assets may be impaired.
- Whether the work of a specialist has been used by the plan.
- Whether receivables have been recorded in the financial statements.
- Whether plan management has apprised the auditor of all communications, whether written or verbal, with regulatory agencies concerning the operation of the plan.
- Management's intention to not terminate benefit responsive investment contracts.
- The effect of new accounting standards.
- The adequacy of all allowances for receivables.
- The information contained in the notes to the financial statements when the notes are in the opinion of plan management (or plan sponsor).

- The reasonableness of significant fair value assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the plan where relevant to the use of fair value measurements or disclosures.
- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements other than normal market fluctuations.
- If the engagement is a limited-scope audit, the plan administrator's responsibilities as they relate to the completeness and accuracy of the trustee certification.
- Whether plan management has obtained and reviewed a service organization's report on internal control (if available) and are performing the applicable user controls.

You should be aware that if plan management refuses to furnish written

representations that the auditor believes are necessary, it may constitute a limitation on the scope of the auditor's services sufficient to preclude the auditor from issuing an unqualified opinion on your plan's financial statements.

Communications About Internal Control Related Matters Identified in an Audit

Internal control is a process – effected by plan management and other personnel, and those charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting.

In performing an audit of your plan's financial statements, your auditors are required to obtain an understanding of the plan and its environment, including its internal control. In doing so, they may become aware of matters related to your plan's internal control that may be considered deficiencies in internal control, significant deficiencies or material weaknesses. Following is a description of each:

Deficiencies in Internal Control. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing

their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

Significant Deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Material Weaknesses. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility (as defined by professional literature) that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Examples of circumstances that may be significant deficiencies or material weaknesses include:

- *Inadequate design of controls over a significant account or process or in the preparation of the financial statements being audited.*
 - Improper valuation of investments, especially alternative investments
 - Plan management must have the ability (methodology and process) to determine reasonableness of actuarial assumptions

- Lack of controls over plan mergers and spin-offs, plan terminations and liquidation accounting
- Lack of controls over accounting for plan amendments
- Lack of controls when changing service providers and ensuring proper information has been transferred to the new service provider
- Failure to properly present and disclose investments (such as securities lending activities, master trusts and alternative investments)
- Inappropriate accounting and disclosure for allocated and unallocated contracts
- Use of incorrect actuarial information in the plan financial statements, for example, the use of actuarial information prepared for the plan sponsor rather than for the plan itself
- Inappropriate expense allocation between multiemployer plans or the sponsoring union
- Expenses incurred but not reported (IBNR), calculated or recorded accurately
- Failure to record discretionary employer contributions, especially in profit-sharing plans
- Errors in census data that result in a material misstatement of obligation information
- *Insufficient control consciousness within the organization.*
 - Plan sponsor has outsourced the administrative functions of the plan with no oversight by management, including not obtaining and reviewing a service organization’s report on internal control, if available
 - Investing in alternative or complex investments without proper due diligence or consideration for the accounting, reporting or regulatory requirements
 - No oversight for monitoring claims paid in a health and welfare plan
 - Lack of performance of tax compliance testing such as discrimination testing or lack of taking appropriate corrective action when errors are found in such testing
 - For multiemployer plans, improper monitoring of cash received from contributing employers
- *Employees or management who lack the qualifications and training to fulfill their assigned functions.*

- Plan sponsor does not have the ability to understand, prepare or review the financial statements

Essentially, the auditor evaluates the severity of each deficiency in internal control identified during the audit to determine whether the deficiency, individually or in combination, is a significant deficiency or a material weakness. The severity of a deficiency depends on (1) the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and (2) whether there is a reasonable possibility that the plan’s controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure. The severity of a deficiency does not depend on whether a misstatement actually occurred. For example, in a situation where the plan sponsor does not have the ability to prepare the plan financial statements, it likely would be considered at least a significant deficiency. And if the person responsible for financial reporting at your plan lacks the ability even to understand the financial statements prepared by the auditor, it likely would be considered a material weakness.

Auditors are required to communicate to management and those charged with governance (see the discussion of persons

charged with governance in the “Auditors Communication With Those Charged With Governance” section above) in writing, significant deficiencies and material weaknesses identified during the audit of your plan. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated. This means that the same matter will be included in the auditor’s written communication until the deficiency is corrected.

The auditor should make this written communication no later than 60 days following the financial statement issuance date (or within 45 days for plans that file a Form 11-K with the SEC). Significant deficiencies and material weaknesses that your auditor communicated verbally during the audit because of their significance and the urgency for corrective follow-up action should ultimately be included in a written communication, even if such significant deficiencies or material weaknesses were corrected during the audit.

Although the auditor is not required to make recommendations for improving internal control, they are not precluded from making such recommendations. If your auditor does not identify any

significant deficiencies, professional standards state that the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

If your auditor issues a written communication regarding internal control related matters identified in an audit of your plan, the following items should be included:

- A statement that indicates the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the plan's internal control.
- A statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- A statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- The definition of the term material weakness and, where relevant, the definition of the term significant deficiency.

- Identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- A statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

You may wish to be proactive and contact your auditor to inquire about the communication requirement and whether your plan should expect to receive such a letter, what deficiencies in internal control the auditor has identified, and any recommendations to improve the plan's internal controls. This will allow you additional time to evaluate the cost/benefit implications of improving your internal control in conjunction with your fiduciary duty to plan participants.

Management Letters and Verbal Communications

As a value-added service, your auditor may make other communications not required by professional standards

Even if your plan auditor does not identify material weaknesses and/or significant deficiencies in internal control that would require written communication with management or those charged with governance, he or she may wish to communicate deficiencies in internal control or other issues or recommendations for improvement noted during the audit. Such comments generally are included in a "management letter." Management letters generally would document the deficiency in internal control or other issue and include a recommendation for remedying the situation. Some auditors may prefer to communicate such matters verbally in a face-to-face meeting.

How Auditor Communications Can Help You

Auditor communications can provide valuable information to help you improve plan operations – and they can also help you meet your fiduciary responsibilities to plan participants.

As a plan sponsor, administrator or trustee, your fiduciary responsibilities include plan administration functions such as maintaining the financial books and records of the plan, and to file a complete and accurate annual return/report for your plan on a timely basis. The communications discussed above will help keep you apprised of issues that may need to be addressed for you to fulfill these responsibilities.

In addition, because errors and fraud can and do occur, it is important that your plan management establish safeguards to prevent or detect such errors and fraud. This can be accomplished by implementing effective internal control over financial reporting. Communications about internal control matters identified in the audit will help improve your awareness of the importance of internal control over financial reporting, and will enable you to assess the costs and benefits of implementing adequate controls that minimize risk for misstatements in your financial reporting process, weigh the risks of each significant deficiency or material weakness, and determine whether and how to address them.

Where to Obtain Additional Information About Auditor Communications

Additional Resources:

AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA Professional Standards, vol. 1), describes the communications auditors are required to make to those charged with governance. It is available on the AICPA's website at aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx

AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA Professional Standards, vol. 1), describes the auditor's responsibility for communicating matters related to your plan's internal control over financial reporting identified in an audit of the financial statements. It is available on the AICPA's website at aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx

AU section 333, *Management Representations* (AICPA Professional Standards, vol.1), describes the auditor's responsibility for obtaining written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards. It is available on the AICPA's website at aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx

AU section 311, *Planning and Supervision* (AICPA Professional Standards, vol. 1), describes the auditors responsibility for establishing an understanding in writing with the client regarding services to be performed. It is available on the AICPA's website at aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx

AICPA Audit and Accounting Guide, *Employee Benefit Plans (the Guide)*, describes various communications auditors make relative to your plan audits. The Guide is available on the AICPA's website at cpa2biz.com.

The AICPA EBPAQC Plan Advisory, *Effective Monitoring of Outsourced Plan Recordkeeping and Reporting Functions*, may serve as a useful tool in understanding communications your auditor may make regarding your plan's internal control. It also provides valuable information about monitoring internal controls at your third-party service providers. That document is available on the Center website at ebpaqc.aicpa.org.

The EBPAQC website includes information that may help you better understand communications you may receive from your auditor, and how they may affect your plan. That information can be found under the "Resources" tab at ebpaqc.aicpa.org

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