AICPA® Employee Benefit Plan Audit Quality Center

Fraud Risk Factors Specific to Employee Benefit Plans

This document was developed to assist members in the consideration of fraud in their employee benefit plan audits. It contains examples of risk factors relating to the two types of fraud an auditor should consider:

- Fraudulent Financial Reporting
- Misappropriation of Assets

Within each of these fraud types, risk factors are further classified based on the three conditions generally present when fraud exists: 1) *incentive/pressure* to perpetrate fraud; 2) *opportunity* to carry out the fraud; and 3) *attitude/rationalization* to justify the fraudulent action.

Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the engagement team may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

I. Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting (Incentive/Pressure, Opportunity, Attitude/Rationalization)

Incentives/Pressures

Financial stability or profitability of the plan is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- Financial stability or profitability of the plan sponsor is threatened by economic, industry, or entity operating conditions
- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable
- The plan has limited investment options or has invested significantly in employer assets other than employer securities
- Poor investment results, especially compared to that of other similar plans
- Recurring negative cash flows combined with an underfunded position or a threat of regulatory intervention to the plan
- The plan sponsor or plan is restructuring (for example, layoffs, spin-offs, plan merger, business combinations, or bankruptcy)
- New accounting, statutory, or regulatory requirements, such as legislation that increases benefits

of public employee retirement plans (PERs) or the Health Insurance Portability and Accountability Act of 1996 (HIPAA) for health care plans that process their own claims

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Public relations risk of large investment that becomes worthless, especially if a derivative or nonregulated investment such as a hedge fund or "alternative investments"
- Investment return expectations of participants, participating employers, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as plan sponsor business combinations or multiemployer plan attempts to attract new employers or to prevent departure of current employers

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Opportunities

The nature of the industry or the plan's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Senior management of the plan sponsor appointing itself trustee of the plan and having the opportunity to that position to benefit the plan sponsor (for example, to use the plan's money for speculative investing or to support the plan sponsor through purchasing employer assets or supporting a supplier)
- Significant related-party transactions not in the ordinary course of business or with related plans not audited or audited by another firm
- Non-readily marketable investments where valuation is based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate, such as unregulated investments (hedge funds or "alternative investments") or real estate
- In-kind contributions from the plan sponsor
- There is ineffective monitoring of management as a result of the following:
- Lack of oversight by plan management of outside service providers such as investment custodians, investment managers, recordkeepers, claims administrators, or paying agents
- Domination of plan management by a single person or small group without compensating controls
- Ineffective board of directors or committee oversight over the financial reporting process and internal controls

- Lack of competence of plan trustees because of background and lack of training

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems including situations involving reportable conditions
- Unusually high levels of participant complaints and corrections to account balances or plan records
- Lack of qualified service provider or change in service provider

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Attitudes/Rationalizations

Auditors may not be able to observe risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting. Nevertheless, if auditors become aware of the existence of such information, they should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the plan sponsor or plan's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Lack of management candor in dealing with plan participants, claimants, outside service organizations, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements
- Failure by management to have adequate valuations performed, including actuarial valuations
- The plan administrator lacks an understanding of the major regulations that govern the plans (for example, Employee Retirement Income Security Act (ERISA), HIPAA, the Internal Revenue Code (IRC), and State legislation)
- Management displays a significant disregard toward compliance with laws and regulations, such as ERISA, HIPAA, IRC, and Department of Labor (DOL)
- The plan administrator custodian or trustees have been investigated by the DOL, Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC), or other party

- The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL. Such participation a possible indication of ineffective management of the plan or controls over the plan

- Management failing to correct known operational deficiencies, prohibited transactions, or reportable conditions on a timely basis

- The named fiduciary is not actively involved in the plan's activities

- There is a high level of plan participant complaints

- There is an overreliance on third party service organizations, lack of monitoring of third party service organizations, and lack of review of outsourced plan operations

The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters

- Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report

- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or oversight committee

- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

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II. Risk Factors Relating to Misstatements Arising From Misappropriation of Assets (Incentive/Pressure, Opportunity, Attitude/Rationalization)

Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur (for example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists).

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. (Access to assets, such as access to participant data communicated to the trustee, may be indirect.)

- Known personal financial pressures affecting employees with access to plan assets

- Adverse relationships between the plan sponsor or plan administration and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs

- Recent or anticipated changes to employee compensation or benefit plans

- Promotions, compensation, or other rewards inconsistent with expectations

- Individuals involved in plan administration known to be dissatisfied

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Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- A company sponsoring multiple defined benefit pension plans, some underfunded, some overfunded

- Lack of qualified outside service provider to serve as trustee and/or custodian of plan assets

- Nonreadily marketable, specialized, or unique investments and management's lack of understanding of such investments (for example, nonregulated investments such as hedge funds and "alternative investments", derivative products, securities lending arrangements, junk bonds, real estate, securities traded in non-U.S. markets, limited partnerships, and real property)

- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Lack of appropriate management oversight

- Lack of review of plan investment transactions including accounting for investment income (for example, by the trustee, sponsor, or the plan's investment committee)

- Lack of segregation of duties or independent checks

- Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan

- Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans

- Plan administrator does not maintain independent records and periodically check information provided to the custodian
- Lack of appropriate system of authorization and approval of transactions
- Lack of complete and timely reconciliations of assets
- Lack of approval of transactions with parties-in-interest that could lead to prohibited transactions
- Lack of timely and appropriate documentation for transactions
- Trustee does not prepare required supplemental information (for example, historical cost records not maintained for non-participant directed accounts)
- Lack of controls over benefit payments, including the termination of payments in accordance with plan provisions
- Lack of segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor
- SOC 1™ report indicating a lack of adequate controls at an outside service provider
- Use of a service provider that does not provide a SOC 1 report
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recorded participant accounts for a defined contribution plan (unallocated assets or liabilities)
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

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Attitudes/Rationalizations

Auditors may not be able to observe risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets. Nevertheless, if auditors become aware of the existence of such information, they should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may observe the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies

- Behavior indicating displeasure or dissatisfaction with the plan or plan sponsor or their treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

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