

WRITTEN TESTIMONY OF
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WORKING GROUP ON PRIVACY AND SECURITY ISSUES AFFECTING
EMPLOYEE BENEFIT PLANS
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I am pleased to submit testimony to the Working Group on behalf of the American Institute of Certified Public Accountants (AICPA) for which I serve as a member of the Employee Benefit Plans Expert Panel and formerly served as a member of the Employee Benefit Plan Audit Quality Center (EBPAQC or the Center) Executive Committee. The EBPAQC is a firm-based voluntary membership center with over 2,100 CPA member firms that audit employee benefit plans. In addition to being a Certified Public Accountant, I am also Certified in Financial Forensics (under the standards of the AICPA) and a Certified Fraud Examiner (under the standards of the Association of Certified Fraud Examiners (ACFE)).

I am Partner in Charge of Assurance Services for Bober Markey Fedorovich, a regional CPA firm with offices in Akron, Ohio and Cleveland, Ohio. Our firm is a member of PKF (“PKF”) North America, an association of approximately 100 independently-owned firms across the United States, and I have chaired their Employee Benefit Plans Committee for the past several years. I have been conducting benefit plan audits for approximately 25 years.

My remarks will focus on fraud in employee benefit plans, including my observations and experiences and how they have helped me recognize fraud risk factors and identify potential fraud. I will also address how I’ve dealt with potential fraud reported to me by plan clients. And, as requested, I will provide information about the Certified Fraud Examiner (CFE) and Certified in Financial Forensics (CFF) designations, and how their services differ from those of a financial statement auditor’s.

Background on the Auditor’s Responsibility with Respect to Fraud

Under auditing standards generally accepted in the United States of America (GAAS), the auditor has a responsibility to plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud. For audit purposes, fraud is defined as an intentional act that results in a material misstatement in financial statements that are the subject of an audit. Fraud is a broad legal concept and auditors cannot make legal determinations of whether fraud has occurred (such determinations can only be made by a court of law.) Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements.

Absolute assurance about whether the financial statements are free of material misstatement caused by fraud is not attainable and thus even a properly planned and performed audit may not

detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the following characteristics of fraud may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent:

- Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Management can either direct employees to perpetrate fraud or solicit their help in carrying it out.
- Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication.
- Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. For example, the auditor may receive a false confirmation from a third party that is in collusion with management.

The auditor has no responsibility to plan and perform the audit to detect *immaterial* misstatements. However, when the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor considers the implications for the integrity of management or employees and the possible effect on other aspects of the audit. Additionally, in an employee benefit plan audit, the auditor would consider whether such matters might represent transactions that might be required for reporting as prohibited transactions.

There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

Because of the characteristics of fraud discussed previously, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. The auditor conducts the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the plan and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Professional standards require that members of the audit team discuss the potential for material misstatement due to fraud prior to or in conjunction with the information-gathering procedures performed in a plan audit. The discussion should include:

- An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors (also known as *fraud risk factors*) affecting the entity that might (a) create incentives/pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. The discussion should occur with an attitude that includes a questioning mind and, for this purpose, setting aside any prior beliefs the audit team members may have that management is honest and has integrity. In this regard, the discussion should include a consideration of the risk of management override of controls. Finally, the discussion should include how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a different period). Therefore, revenue is a presumed fraud risk, meaning the auditor should presume that there is a risk of material misstatement due to fraud relating to revenue recognition. For employee benefit plans, this risk of misstatement due to fraudulent financial reporting primarily includes investment income resulting from inappropriate investment income (either an understatement or an overstatement) resulting from inappropriate investment valuation and the inappropriate recognition of contributions. The AICPA has identified a number of fraud risk factors specific to employee benefit plans, which are outlined in the attached *Fraud Risk Factors Specific to Employee Benefit Plans*.

During the audit, the auditor performs procedures to obtain information that is used to identify the risks of material misstatements due to fraud, including:

- Making inquiries of management and others within the plan to obtain their views about the risks of fraud and how they are addressed.
- Considering any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit.
- Considering whether one or more fraud risk factors (events or conditions that indicate incentives and/or pressures to perpetuate fraud, opportunities to carry out the fraud, or attitudes and/or rationalizations to justify a fraudulent action) exist.

- Considering other information that may be helpful in the identification of risks of material misstatement due to fraud.

When audit test results identify misstatements in the financial statements, the auditor considers whether such misstatements may be indicative of fraud. If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, he or she must attempt to obtain additional audit evidence to determine whether fraud has occurred or is likely to occur, consider the implications for other aspects of the audit, discuss the matter with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee and, if appropriate, suggest that the client consult with legal counsel. The auditor may, in certain circumstances, need to consider withdrawing from the engagement.

Observations and Experiences

You also asked me to address how common fraud is in employee benefit plans. While I don't have statistics regarding the incidence of fraud in employee benefit plans, I have made the following observations, in no particular order:

1. Auditors whose firms are members of the AICPA's EBPAQC are significantly better educated in the unique issues that can give rise to fraud in an employee benefit plan and have more resources available to them, due to the efforts of the EBPAQC to educate CPAs as to the risks of fraud and to provide tools and examples to CPAs as to where fraud could occur within a plan audit. Unfortunately, it is my understanding that the DOL has no regulatory authority to require plan auditors to be members of the EBPAQC, thus a large number of audits are still conducted by firms that are not members and a great many of them are not even members of the AICPA.
2. In my practice, we have seen very few instances of fraud in employee benefit plans. I believe the primary reason for this is that, due to the extensive use of third party trustees/custodians/administrators, some of the opportunities that someone at the plan sponsor may have to commit such an act are mitigated because they do not have ready access to funds that are held by others, and often the internal controls of those third parties are examined pursuant to professional standards (Statement of Auditing Standards (SAS) No. 70, *Service Organizations*, now Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization*), to provide some level of testing assurance to plan auditors with regards to those controls. Where (for example) I could see an increased risk of fraud would be in situations where a plan sponsor might be self-administering its plan and where the plan trustees are not independent of the plan. Many years ago there were a number of situations where plan sponsors would self-administer their plans, but I am really not seeing much of that anymore.
3. I personally have approximately 25 years of experience in conducting employee benefit plan audits. In all of those years, I have seen very little that I considered indicators of fraud. I have seen evidence of sloppy bookkeeping, reportable and prohibited transactions, lack of plan sponsor oversight of plan management, a wide variety of

significant deficiencies and material weaknesses in internal controls (as defined in SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, but very few indicators of an intentional act with the intent to deceive the reader of the financial statements or to cover-up for a theft of plan assets.

4. Thanks to the EBPAQC, the materials published by the AICPA, and a variety of training courses and conferences conducted by the AICPA as well as many of the individual state CPA societies, and also thanks to the DOL's own outreach program, I do believe the word has gotten out to CPAs across the country to watch carefully for timeliness of participant contributions. I have seen a lot of reporting on this, but I have not yet seen a circumstance amongst my clients where I would consider their untimely contributions to be an intentional act, and thus not within the definition of fraud.
5. I have personally been involved in committees through the AICPA for the past five years – the first three years through the EBPAQC Executive Committee and the past two years as a member of the EBP Expert Panel. Furthermore, for the past several years I have chaired the Employee Benefit Plans Committee for PKF. These committee interactions have provided me significant opportunity to interact with CPA firms nationwide and with varying sizes of firms. I have a few observations from these interactions to share with you:
 - a. The CPAs I talk to today are significantly more sensitive to risks of fraud in a benefit plan audit than they were five years ago. I attribute that to the extensive training that has been conducted in this field and a number of items that have been published and shared through the EBPAQC.
 - b. I have been strongly encouraging EBPAQC membership for PKF firms that perform plan audits and am pleased to say that the vast majority of these firms have indeed joined the Center and thus are benefiting from the tools to help them better understand the risks of fraud in benefit plan audits. I, and other members of my committee, have also conducted a number of continuing education courses through PKF to get the word out.
 - c. I continue to be concerned about small CPA firms around the country that are conducting plan audits but have not chosen to be members of the AICPA and/or the EBPAQC (membership is voluntary), as they may not have the resources necessary to be able to properly understand where those fraud risks lie, and thus may overlook such risks in planning their audits. Our outreach programs don't seem to reach these firms for a variety of reasons including (but not limited to):
 - i. If they only do a few plan audits, the work may not seem important enough to them to get any specialized training;
 - ii. They may not feel that they have the time or resources to subject themselves to the requirements of membership in the Center;
 - iii. Many small firms have a heavy tax focus to their practices and the plan audit may be the only audit work they do; thus their tax practitioners conducting this work may not fully comprehend the importance of some of the procedures necessary to perform these audits.

As discussed above, fraud risk factors are events or conditions that indicate incentives and/or pressures to perpetuate fraud, opportunities to carry out the fraud, or attitudes and/or rationalizations to justify a fraudulent action. In today's economic environment, there are many factors that may increase the risk of fraud against a plan. Specifically, there may be incentives or pressures to commit fraud caused by the effect of the current economic environment on individuals that may have access to the plan's assets. The financial stability or profitability of some plans may be threatened by economic conditions such as poor investment results; the financial instability of the plan sponsor; recurring negative cash flows combined with an underfunded position, and new accounting, statutory, or regulatory requirements, such as legislation such as the Health Insurance Portability and Accountability Act of 1996 (HIPAA) for health care plans that process their own claims. These risk factors can and will change every year, and the audit process should address risks relevant to the year under audit.

In addition to my personal experiences, the AICPA EBPAQC prepared two tools, which are attached, that summarize actual fraud cases perpetrated at plans. The first, *Employee Benefit Plan Fraud Examples*, summarizes actual fraud cases compiled from submissions by auditors of employee benefit plans. The second, *Employee Benefit Plans DOL Criminal Enforcement Cases, January 2006 – March 2009*, is a summary analysis of the U.S. Department of Labor (DOL) Employee Benefit Security Administration's criminal enforcement actions involving employee benefit plans during the period January 2006 through March 2009. Additionally, the AICPA has provided a variety of continuing education seminars to auditors in the area of fraud risk assessments, including sessions at each of the last several National Conferences on Employee Benefit Plans conducted by the AICPA and attended by several members of the DOL.

Certified Fraud Examiner (CFE) and Certified in Financial Forensics (CFF) Credentials

The Certified Fraud Examiner (CFE) credential has been around for a long time and is available to CPAs and other professionals who meet these minimum qualifications and pass an examination:

- Be an Associate Member of the ACFE in good standing
- Meet minimum Academic and Professional requirements
- Be of high moral character
- Agree to abide by the Bylaws and Code of Professional Ethics of the Association of Certified Fraud Examiners

Generally, applicants for CFE certification have a minimum of a Bachelor's degree (or equivalent) from an institution of higher learning; no specific field of study is required and fraud-related professional experience can substitute for the education requirement. At the time of certification, candidates must have at least two years of professional experience in a field either directly or indirectly related to the detection or deterrence of fraud. CFEs must obtain a minimum of 20 hours of Continuing Professional Education (CPE) every 12-month period to maintain their certification, of which 10 must be fraud related and 2 must be ethics related. Many CFEs work in law enforcement, while many others work in fraud consulting practices or in industry as internal auditors, fraud risk managers, or other similar positions.

The AICPA established the Certified in Financial Forensics (CFF) credential in 2008 specifically for CPAs who specialize in forensic accounting. The CFF credential is granted exclusively to CPAs who demonstrate considerable expertise in forensic accounting through their knowledge, skills, and experience. The CFF encompasses fundamental and specialized forensic accounting skills that CPA practitioners apply in a variety of service areas, including fraud prevention, detection, and response and financial statement misrepresentation. To qualify, a new CFF applicant must:

- Maintain an AICPA membership in good standing
- Have a minimum of 1,000 hours of business experience in forensic accounting within the 10-year period preceding the date of the CFF application
- Hold a valid and unrevoked CPA certificate or license issued by a legally constituted state authority.
- Pass the CFF examination.
- Have 75 hours of forensic accounting related continuing professional education (CPE). All hours must have been obtained within the 10-year period preceding the date of the CFF application, with at least 50% obtained in the 5-year period preceding the credential application.
- Sign a Declaration of Intent to comply with the requirements of CFF recertification.

To maintain the certification, a CPA must maintain an AICPA membership in good standing, hold a valid and unrevoked CPA certificate or license issued by a legally constituted state authority; obtain at least 60 hours of forensic related CPE over the preceding three years; and submit electronic intent to continue to comply with all recertification requirements.

The CFF credential is a demonstration of a CPA's commitment to understanding and applying forensic accounting skills. These skills go well above and beyond those which are necessary to conduct an audit of financial statements in accordance with GAAS. For example, CFF's may participate in consulting or agreed-upon procedures engagements to assist clients (companies, benefit plans, legal counsel, etc.) in detailed assessments as to whether evidence exists that might indicate a fraud, investigations to better understand and document the extent of a fraud, or serve as expert witnesses in litigation.

CPA firms that employ professionals with the CFF credential also may, if they and their clients feel it appropriate, engage the CFF in extended audit procedures during a GAAS audit if the audit team has encountered a matter it considers to be an indicator of possible fraud. In such cases, it is important that audit teams use due professional care in the investigation of the matter so that evidence is properly identified and handled. Failure to do so could jeopardize the admissibility of such evidence in a court of law. While many CFF's have the experience and skills to conduct these specialized investigations, CFF services generally are not necessary for a GAAS audit unless the audit team encounters some indication of potential fraud.

Conclusion

Thank you for your interest in this important matter and the opportunity for me to submit testimony to the Working Group.