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ADP Lunch & Learn
Course Materials

Auditing Employee Benefit Plans

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4. Auditing Employee Benefit Plans

Learning Objectives:

Upon successful completion of this segment, you should be able to:

- Recognize why fiduciary responsibility for employee retirement plans is topical;
- Recognize the difference between a full and limited scope audit of an employee retirement plan;
- Identify the control deficiencies that are most likely to occur;
- Identify the approaches for correcting operational deficiencies.

Segment Overview:

Maintaining and retaining documentation are two of the most important responsibilities of employee benefit fiduciaries. Not only is it useful to have the appropriate documentation to support historical plan activities and participant elections regarding investment choices, distribution and requests, it is also required by the IRS and the Department of Labor to support the information reported on Form 5500 filings. Here, *David Dacey*, a partner and practice leader of the Employee Benefit Plan Services Group with WithumSmith+Brown, clarifies what auditors should look for when auditing employee benefit plans and identifies the common mistakes companies make when they administer these plans.

Field of Study: Auditing

Expiration Date: August 31, 2017

Course Level: Update

Course Prerequisites: Work experience in financial reporting or auditing, or an introductory course in accounting

Advance Preparation: None

Recommended Accreditation: 1 hour group live
2 hours self-study

Required Reading (Self-Study): "Three Articles by David Dacey"
For additional information, go to: http://www.withum.com/

See page 4–11.

Video Transcript: See page 4–16.

Running Time: 34 minutes

Outline

I. Fiduciary Responsibility

A. Definition of Fiduciary Responsibility
   1. Maintaining and retaining documentation
      a. One of the most important responsibilities of employee benefit plan fiduciaries
   2. Also required by the Internal Revenue Service and Department of Labor
      a. To support the information reported on Form 5500 filings
   3. Employment Retirement Income Security Act (ERISA)
      a. Requirement for plan sponsor who oversees an employee benefit plan to act in a fiduciary responsibility

B. Increased Focus on Fiduciary Responsibility
   1. Department of Labor EFAST 2 database to harness 5500s
      a, And every associated financial statement for larger plans
   2. 2012 – DOL came out with Section 408(b)(2)
      a. New regulations related to service provider fee disclosures
      b. Required more transparent look at fees charged to plans
      c. Participants allowed to sue fiduciaries for breach of fiduciary responsibility

C. Increased Transparency
   1. 5500 is public information – accessible to everybody
   2. Department of Labor scrutinizing the form 5500 database
      a. Looking closely at how form is filled out
         i. Whether there are any inconsistencies
   3. Section within the 5500 called the schedule C
      a. Highlights all the fees being paid out by the plan
      b. Causing a lot more price competition and transparency

Outline (continued)

II. Financial Statement Audits

A. 80-120 Rule
1. Not every retirement plan requires audited financial statements
2. Once a plan (as of the beginning of the year) has 121 eligible participants
    a. Required to have a plan audit
3. If number of eligible participants dips below 100
    a. Plan no longer requires audited financial statements

B. Participant Requirements
1. 5500 database has a field of information for eligible or number of participants as of the beginning of the year
    a. To identify any plan that has over 121 eligible participants
        i. Or 100 participants if you met the 121 eligibility requirement in prior years
2. Measure that against whether there's an attached set of financial statements

C. Limited Scope Audit Exception
1. No certification allowed on contributions, distributions, and administrative expenses
2. Limited scope engagements really deal toward certifying just investments

D. Partial Termination
1. Occurs when >20% of a workforce is laid off at a particular point in time
    a. Those participants become 100 percent vested in the plan
2. High likelihood that there was a partial termination if:
    a. Distributions as percentage of beginning-of-year net assets >20%
    b. Plan would want to make sure that affected participants who were affected became 100% vested
        i. Unvested shouldn't be erroneously categorized as forfeitures

III. Limited vs. Full Scope Audits

A. Requirements for Limited Scope Audits
   1. Limited scope audit does not require auditor to audit investment activity and balances within a plan
   2. Limited scope audit is permitted if a bank or insurance company issues a certification of investment activities and balances

B. Full Scope Audit
   1. Tests contributions and distributions and administrative expenses
   2. Auditor would look at
      a. Balances
      b. Investment transactions
      c. Would make sure that market values are what the investment company is using

         "It's a much more robust look at investments than you would otherwise have if you were to do a limited scope audit where you're essentially accepting a certification from an acceptable party."

         \- David Dacey

C. Limited Scope Audits with Form 5500
   1. Investment houses holding plan's investment assets did a lot of lobbying
      a. Said they were heavily regulated to begin with
      b. Were able to certify completeness and accuracy of investment data
   2. Permitted certification as an alternative to doing the full scope audit procedures for investments

D. Limited Scope Audits Less Costly
   1. Less costly to have a limited scope audit
      a. With the understanding that investments are certified by the vestment house
         i. As to completeness and accuracy
   2. Participant protection is an important aspect of either type of audit
      a. Contributions need to occur in accordance with 401K plan contract
      b. May be loan or distribution provisions within the plan document

IV. Audit Tests

A. Prohibited Loans
   1. Expectation that monies are being deposited in as timely a basis as possible
      a. If that that doesn't happen
         i. DOL considers that to be a prohibited loan
   2. Audits test that type of thing
      a. Make sure that once the money is withheld from the participant
         i. It's being deposited for the participant's benefit as soon as possible

B. Testing Timeliness of Deposits
   1. Compare date of 401K withholdings to the date on which the proceeds were deposited in the investment trust account
   2. Timing depends on when the plan's sponsor can reasonably segregate the assets
      a. And come up with the appropriate administrative processes
   3. If not done on a timely basis
      a. Financial reporting that needs to occur
         i. There's 5500 reporting
         ii. There might be DOL scrutiny

IV. Audit Tests continued

C. Appropriate Contributions and Deposits
   1. Plan document will dictate when someone becomes eligible to participate
      a. Eligibility provisions need to be in line with ERISA
   2. Verify that the amounts withheld were the amounts that were actually deposited
   3. Look at things like elective deferral percentages
      a. If someone changed their percentage during the year

V. Finding Audit Mistakes

A. Operational Deficiencies
   1. To the extent that the plan is not operating in accordance with the plan document
      a. There's an operational deficiency
         i. Operational deficiencies could jeopardize the tax status of the plan
   2. Could actually cripple a company
      a. To the extent that withholdings from a participant were deposited in a plan
         i. And the participant deducted that on their tax return
         ii. They would theoretically be disallowed to do so

B. Self-Correction and Voluntary Compliance Program (VCP)
   1. Could self-correct
      a. Self-correction is the most economical thing for a plan to do
   2. Could go into the voluntary compliance program
      a. Has a fee based on number of participants
   3. Audit CAP program
      a. You've already been investigated and the IRS is aware of the problem
      b. Penalties are much stiffer for that type of program

C. Economics of Self-Correction vs. VCP
   1. Example: if a deposit was deemed to be untimely
      a. For the number of days it was late the plan would calculate lost interest
   2. To take advantage of self-correction
      a. Need to be in good standing from a tax perspective
      b. Need a current IRS determination letter or approval letter

VI. Plan Weaknesses

A. Timeliness Weakness
   1. Biggest weakness is the timeliness of deposit issue
   2. Rule is that participant withholdings need to be deposited as soon as the funds can be reasonably segregated
      a. No later than the 15th of the following month

B. Definition of Compensation
   1. Example: Plan document says, "We're going to base elective deferrals and employer matching contributions based on total compensation."
   2. Total compensation can include things like bonuses and overtime
      a. Plan may not be operating that way
      b. May be excluding those bonuses
      c. There's an operational deficiency that needs to be corrected

C. IRS 401K Fix-It Guide
   1. Articulates the top ten operational deficiencies that a plan has
   2. Gets into how the error occurs, what to do if you have the error, and how to prevent the error from occurring
   3. IRS says the best way to prevent operational deficiencies from occurring is to have good internal controls in place

D. Tone at the Top Increasingly Important
   1. With increased transparency on these plans tone at the top and solid control environments are critical
   2. There's only going to be increased scrutiny and increased transparency

"Really having a good tone at the top and having good processes in place and good control environment, and the like is really important to a plan."

\- David Dacey

VII. Going Forward

A. Need Increased Transparency and Scrutiny
   1. Increased transparency and scrutiny of plans is critical
   2. Plan sponsors should have more focus than ever
   3. DOL is marrying up the state of domicile of the plan
      a. With the accounting firm that is performing the audit of the plan
      b. Working with state boards of accountancy to see if those firms are properly licensed in that particular state

B. Changes in Content and Format of Audit Report
   1. Content of the audit report in 2012 changed
      a. Format of the audit report changed
   2. DOL wrote an algorithm to look at the 5500 database
      a. Looked for certain phrasing in the audit report
      b. If phrasing didn't exist that was an indicator that the auditor wasn't using the right audit report

C. Documenting and Following Policy
   1. Fiduciary has a responsibility to make sure that fees charged to a plan are reasonable
   2. Have policy statements that are being followed
   3. Have investment committees in place
   4. Have good solid oversight over operational processes of a plan

Group Live Option

Instructions for Segment

For additional information concerning CPE requirements, see page vi of this guide.

- As the Discussion Leader, you should introduce this video segment with words similar to the following:

  "In this segment, David Dacey clarifies what auditors should look for when auditing employee benefit plans and identifies common mistakes companies make when administering these plans."
- Show Segment 4. The transcript of this video starts on page 4–16 of this guide.
- After playing the video, use the questions provided or ones you have developed to generate discussion. The answers to our discussion questions are on page 4–8. Additional objective questions are on pages 4–9 and 4–10.
- After the discussion, complete the evaluation form on page A–1.

Discussion Questions

4. *Auditing Employee Benefit Plans*

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. Why is fiduciary responsibility topical?
2. What is the 80-120 rule?
3. What is the difference between a full and limited scope audit of an employee retirement plan? What is your experience with audits of employee retirement plans?
4. What is involved with testing the timeliness of deposits? Contributions?
5. What are examples of common operational deficiencies in employee retirement plans?
6. What are the approaches a company can take to correct operational deficiencies?
7. What are some examples of the increased regulator and business scrutiny of employee retirement plans?

4. Auditing Employee Benefit Plans

1. Why is fiduciary responsibility topical?
   - Why fiduciary responsibility is topical
     - DOL's EFAST2: 5500's now public information
     - DOL's Section 408(b)(2): Service provider fees disclosed
     - LaRue v. DeWolff: Participants can sue fiduciaries

2. What is the 80-120 rule?
   - 80-120 rule
     - Once retirement plan has 121 eligible participants: Plan audit required
     - Rule stays in effect until eligible participants less than 100

3. What is the difference between a full and limited scope audit of an employee retirement plan? What is your experience with audits of employee retirement plans?
   - Full versus limited scope audit
     - Full Scope: Investment activity and balances required
     - Limited scope: Audit of investment activity and balances not required
     - 70% of financial statements filed: Limited scope audit
   - Response is based on participant experience

4. What is involved with testing the timeliness of deposits? Contributions?
   - Testing the timeliness of deposits
     - Compare date of employee withholding to date of deposit into investment account
   - Testing contributions
     - Eligibility
     - Amounts withheld deposited
     - Elective deferral percentages

5. What are examples of common operational deficiencies in employee retirement plans?
   - Dacey's experience with weaknesses
     - Timeliness of deposits
     - Definition of compensation

6. What are the approaches a company can take to correct operational deficiencies?
   - Correcting operational deficiencies
     - Self-correction: Most economical
     - Voluntary Compliance Program: Fee based on number of participants
     - Audit Cap program: More costly

7. What are some examples of the increased regulator and business scrutiny of employee retirement plans?
   - Increased regulator and business scrutiny
     - DOL comparing plan's state of domicile with accounting firm to determine firm is properly licensed
     - DOL looking at phrasing of audit report
     - Service providers looking at fees

Objective Questions

4. Auditing Employee Benefit Plans

You may want to use these objective questions to test knowledge and/or to generate further discussion; **these questions are only for group live purposes.** Most of these questions are based on the video segment, **a few may be based on the required reading for self-study** that starts on page 4–11.

1. What factors are contributing to the increased focus on fiduciary responsibility in the context of employee retirement plans?
   a) The EFAST2 Database has made all form 5500s public.
   b) more transparency regarding fees charged to plans as a result of Section 408(b)(2)
   c) lawsuits where plan participants have sued their fiduciaries for breach of fiduciary responsibility
   d) all of the above

2. According to David Dacey, what is a common issue that can be picked up from a quick read of plan financial statements?
   a) whether, based on plan assets, a limited scope audit would have been permitted
   b) the failure to certify contributions in a limited scope audit
   c) whether or not a partial termination is likely to have occurred
   d) whether timeliness of deposits is an issue

3. How does a full scope audit differ from a limited scope audit?
   a) Only a full scope audit would test the balances for contributions, distributions, and administrative expenses.
   b) Only a full scope audit requires the auditor to audit the investment activity and balances within a plan.
   c) Only a full scope audit tests participant data.
   d) A limited scope audit is only an available option for smaller plans.

4. What does David Dacey note regarding limited scope audits?
   a) He recommends that fiduciaries opt for a full scope audit in order to shield themselves from liability.
   b) The rationale behind them is that investment houses are already heavily regulated.
   c) They generally don't do enough with respect to participant protection.
   d) He believes they will eventually be phased out in favor of full scope audits.

5. What would be considered a timely deposit in terms of employee retirement plans?
   a) as soon as the funds are reasonably segregable
   b) one week
   c) one month
   d) 10 days

6. In terms of operational deficiencies, David Dacey notes that:
   a) An approval letter must be in place to take advantage of the voluntary compliance program.
   b) Self-correction is not recommended.
   c) The Audit CAP program has a fee based on the number of participants that a plan has.
   d) The penalties are the stiffest for the Audit CAP program.

Objective Questions (continued)

7. According to David Dacey, which of the following deficiencies are most likely to occur?
   a) Partial terminations are not handled appropriately.
   b) Eligibility requirements are not properly followed.
   c) The definition of compensation is not properly applied to deferrals and matching contributions.
   d) Deposits are not made in a timely fashion.

8. What does the required reading note with respect to timeliness of deposits?
   a) The safe harbor provision will go into effect for 2016.
   b) Employers may apply for an extension of ten days.
   c) Deposits made on behalf of the participant by the 15th day of the following month would not be considered delinquent.
   d) Late deposits would generally not be considered prohibited transactions.

9. With respect to a certification in connection with a limited scope plan audit, the required reading emphasizes that:
   a) the certification should extend to contributions and distributions.
   b) only plans with less than 100 plan participants are eligible for a limited scope audit.
   c) the certification should only cover investment activity.
   d) the certification must come from a bank.

10. What does the required reading note in terms of partial terminations?
    a) Errors in this area would result in the misstatement of plan balances for affected participants.
    b) Affected plan participants would forfeit any non-vested balances in the plan.
    c) The calculations to determine if a partial termination may have occurred are cumbersome.
    d) Distributions that represent 10% or more of beginning net assets would indicate a partial termination occurred.

Self-Study Option

Instructions for Segment

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes). The transcript of this video starts on page 4–16 of this guide.
2. Completing the Required Reading (approximately 25–30 minutes). The Required Reading for this segment starts below.
3. Completing the online steps (approximately 35–45 minutes). **Please see pages iii to v at the beginning of this guide for instructions on completing these steps.**

Required Reading (Self-Study)

THREE ARTICLES BY DAVID DACEY

For additional information, go to:
http://www.withum.com/

FIDUCIARY DUTY AND TIMELINESS OF 401(K) PARTICIPANT DEPOSITS

By David R. Dacey
For additional information, go to:
http://www.withum.com/kc/401k-participant-deposits/

Protecting the children's money! In listening to presentations made by the U.S. Department of Labor (DOL), protecting the interest of 401(k) plan participants is also protecting the interest of their families. One expectation from the DOL in this regard is that plan sponsors remit 401(k) participant deposits on a timely basis. How do plan sponsors meet this requirement? Let's start by reviewing the written rule by the DOL.

The Written Rule:

Employers are required to remit employee contributions to the plan as soon as they can be reasonably segregated from the employer's general assets, but no later than the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer [DOL Reg. 2510.3-102(b)]. Employers may apply for an extension of 10 days.

What Does The Above Mean?

The term "reasonably segregated" means that as soon as the employer has remitted payroll to the employee, knows what the required deposit is for the withheld employee benefit plan contributions, and can segregate the funds from the employer's general assets, the employer is required to remit the contributions to the custodian. The confusing aspect of the above rule relates to the term "no later than the 15th business day of the month following the month in which the participant contributions are withheld."

When comparing these two concepts, the DOL has ruled that the "reasonable segregation" requirement overrides the "no later than 15th business day" exception.

Meeting the DOL Requirement:

Making timely participant deposits is an important part of the plan sponsor's fiduciary responsibility. But how do plan sponsors demonstrate that they have met their fiduciary responsibility? To answer this question, consider the following hypothetical example below, (assumes the plan has 100 or more participants):

Interpreting the Chart:

Based on the limited example, (which is limited in part because it is calculated on actual days and should be based on business days), the Company has demonstrated that the amount of the required withholding can be determined within four days of the date of the payroll. A DOL agent could construe this to be a benchmark for determining lateness of deposits in accordance with the above regulation. Deposits that are considered to be delinquent are considered to be prohibited transactions, which could be subject to excise taxes, plus reimbursement to the Plan by the plan sponsor for earnings lost by the participant due to the lateness of the deposit. For 2009, delinquent deposits are required to be reported on Form 5500 and as a supplemental schedule to the audited financial statements.

New Development Seven Business Day Safe Harbor for Small Plans:

In January 2010, the DOL issued final regulations, which permits pension and welfare plans with fewer than 100 participants, a seven business day window to remit the participant's deposit. The seven business day window starts from the date of receipt by the employer (in the case when the participant makes a payment directly to the employer) or the payroll date (in the case when the employer is withholding elective deferrals on behalf of the participant). This seven business day safe harbor is not available to plans with 100 or more participants. Such plans should continue to follow the rules above.

Fiduciary Recommendation:

Fiduciaries are well advised to have their staff track timeliness of deposits in a table or format similar to the above example, in an effort to demonstrate their responsibility over this process. Differences between normal trends should be explained to further demonstrate this responsibility. Documentation is the key!

WITHHOLDING DATE	AMOUNT WITHHELD	DATE RECEIVED BY INVESTMENT CUSTODIAN	NUMBER OF DAYS	IS THE DEPOSIT LATE?
1/15/2009	$12,400	1/19/2009	4	Probably Not
3/17/2009	$12,600	3/21/2009	4	Probably Not
5/20/2009	$13,000	5/26/2009	6	Maybe
8/17/2009	$12,100	8/27/2009	10	Probably
9/25/2009	$10,500	9/30/2009	5	Maybe
11/18/2009	$12,500	11/23/2009	5	Maybe
12/5/2009	$12,700	12/10/2009	5	Maybe

401(K) PLAN FINANCIAL STATEMENT OVERSIGHT: START WITH THE LOW HANGING FRUIT

By David R. Dacey
For additional information, go to: http://www.withum.com/kc/401k-plan-financial-statement-oversight-start-low-hanging-fruit/

There have been several events in the last few years, which should cause fiduciaries of employee benefit plans to take particular notice:

E-fast2 has made every financial statement, which is attached to Form 5500, public information. This means that anyone with a computer can review any plan's Form 5500, along with the financial statements that have been attached to the 5500.

The Department of Labor (DOL) has recently hired as many as 1,000 new inspectors to inspect employee benefit plans, and these inspectors are armed with analytical information, collected from the Form 5500 on the e-Fast2 database.

The recent fee disclosure rules for covered service providers (ERISA Section 408(b)(2)) and participant fee disclosures (ERISA Section 404(a)(5)) have also increased transparency of fees in employee benefit plans, resulting in further increased transparency of a fiduciary's performance for their employee benefit plan.

If these events were not compelling enough, there have also been several high profile court cases against plan fiduciaries (most notably Tussey vs. ABB). The decisions in these court cases have set the stage for future challenges against plan fiduciaries. Put all these events together, and the message is clear. Fiduciaries need to be on top of their game when it comes to publicly reported information related to their employee benefit plans.

How can a fiduciary be "on top of their game"? The answer to this question should ultimately result in having a comprehensive and robust process at the plan to deal with the various fiduciary issues that face the plan. Notwithstanding this robust process, one easily implemented process is to identify "low hanging fruit", or obvious potential issues in a plan's financial statements, which could trigger challenges to the fiduciary with respect to their responsibilities over the plan. The following serves to provide three examples of such low hanging fruit, for which plan fiduciaries should be mindful, when reading their plan's publicly reported financial statements.

While these few examples are certainly not all-inclusive, it does illustrate the need to actively review financial statements for obvious potential financial reporting issues.

1. Low Hanging Fruit Example #1: Using an Incorrect Auditor's Report

New for calendar year 2012 employee benefit plan financial statements, (note: the actual effective date is for years ending after December 15, 2012), a new set of auditing standards, known as the clarity standards, will be effective.

One of the more significant aspects about these new "clarity" auditing standards is that both full-scope and DOL limited scope audit engagements will each require a new independent auditor's report, which are both distinctly different from their predecessor auditor report issued for 2011 plan financial statements.

Each of the new auditor's reports, which are to be used for "non-public" plan financial statements, has distinct wording changes and is highlighted by the inclusion of specific section headings, which have not been seen in prior auditor reports. These section headings include, but are not necessarily limited to, management's responsibility for the financial statements, the auditor's responsibility, the auditor's opinion, and other matters. It is also important to note that plan financial statements filed on Form 11-K with the Securities and Exchange Commission will not use this report, but instead will continue to use a report specifically required by the Public Company Accounting Oversight Board.

Using the incorrect auditor report could raise questions about the expertise of the plan's auditor, which in turn could raise questions about the fiduciary's prudence in selecting the auditor.

2. Low Hanging Fruit Example #2: Incorrectly Disclosing Certified Contributions / Distributions

Approximately 70% of the financial statements submitted to the Department of Labor are considered "limited scope audit engagements". These engagements, which are filed with the DOL pursuant to Code of Federal Regulation, 29 CFR 2520.103-8 provides a scope exception for financial statements issued with the DOL that the audited financial statements do not require the audit of certified investments in a plan, and limit an auditor's procedures of investments to primarily comparing certified investment data to amounts reported in the financial statements.

It is important to note that in order for the certification to be acceptable to the auditor, the underlying investment data must be certified as complete and accurate, and must be received from [1] a bank, trust company or similar institution or [2] an insurance company, since these entities are subject to regulatory oversight. Further, the limited scope exemption does not extend to other non-investment assets or activity.

Accordingly, an acceptable certification would not extend to plan contributions or distributions, since this activity is not investment related. Any financial statements, which disclose contributions or distributions as certified financial statement data, contradicts the regulations and demonstrates a lack of prudence over financial reporting.

3. Low Hanging Fruit Example #3: Beware the Partial Termination!

During difficult economic times, significant workforce terminations can be a common occurrence. Plans should be mindful that such terminations could impact the operations of their retirement plans. A large termination of a workforce could result in an issue, known as a "partial termination". The significance of a partial termination is that all affected employees would immediately 100% vest in any employer contributions to their retirement plans. Plans that do not properly account for partial terminations, could erroneously overstate their plan's forfeitures and understate the vested retirement plan balances for the terminated participants. The generally accepted benchmark for identifying a partial termination is a termination of 20% or more of a company's workforce, resulting from the termination initiative. It is important to note, that such terminations are not required to happen within any given year (e.g., terminations could overlap over several years).

Fortunately, there is a quick and easy metric that a fiduciary can use that may identify whether there might be a partial termination. This metric compares the relationship of distributions per the statement of changes in net assets available for benefits (the numerator) to total beginning of the year net assets (the denominator).

If distributions represent 10% or more of total beginning net assets, it is worth additional inquiry to determine whether there may have been a partial termination at the company. Using this lower percentage helps to account for partial terminations which may overlap between years or terminations of employees with smaller retirement plan balances. If the ratio of distributions to beginning of the year net assets is 20% or more, fiduciaries should ask the question more often and with greater emphasis. This issue should be discussed with the plan's legal counsel.

Utilizing this easy to calculate and effective metric can potentially stem off an operating issue for the plan and helps demonstrate strong fiduciary oversight.

Implementing and maintaining a quality fiduciary process can be thought of as a journey, which begins with a single step. Dealing with the low hanging fruit of publicly reported financial statements is an ideal way to begin that journey!

Low Hanging Fruit: Lessons Learned

The three examples presented above are far from all-inclusive. Instead, they represent just a few obvious indicators of potential issues facing the plan. So what global lessons can be applied from considering these few examples?

- *Actively review your plan's publicly reported documents*. It is important to remember, that your plan is on public display, for anyone with a computer to see and as a result, these aspects of the fiduciary's performance are also on display. It is important that plans be mindful of this fact, and act accordingly when displaying public information. If an issue doesn't seem typical or appears to be improper, it might be low hanging fruit and should be evaluated.

- *Ask your plan professionals*. To paraphrase a famous advertising slogan from several years ago, "An educated fiduciary is our best client!" A plan's professionals (auditors, attorneys, actuaries, fiduciary advisors, etc.) all stand ready to help their clients become better educated in their responsibilities as plan fiduciaries. Ask your professionals questions about potential low hanging fruit issues to increase your knowledge base. Better education benefits everyone and helps better ensure that plans are acting in the best interest of the participants. This philosophy certainly applies to publicly reported financial information for the plan.

- *Document your process*. In today's world, documentation is everything! It is the best way to demonstrate that procedures were actually performed, and it serves as a great reminder of those processes, which should be performed on a continual basis. Maintaining well-organized, referenced and documented processes and resolutions to potential issues serves overall plan quality. You value what you measure!

Implementing and maintaining a quality fiduciary process can be thought of as a journey, which begins with a single step. Dealing with the low hanging fruit of publicly reported financial statements is an ideal way to begin that journey!

WHEN IS A RETIREMENT PLAN AUDIT REQUIRED?

By David R. Dacey
For additional information, go to:
http://www.withum.com/kc/retirement-plan-audit/

Understanding when audited financial statements of a retirement plan are required to be attached to a Form 5500 is an important part in demonstrating fiduciary responsibility over the plan and preventing unnecessary fines for an invalid filing of the 5500. The following are important concepts for understanding if your plan needs an audit of the financial statements:

- Determining whether an audit is needed is based upon the number of eligible participants (and not just actual employees participating) as of the beginning of the plan year. As an example, a 401(k) plan might have only 20 employees actually participating, but if 150 employees are eligible, the plan would require in audit.

- The mandatory audit requirement begins when the number of eligible participants reaches 121 at the beginning of the plan year.

- Upon reaching 121 eligible participants, the mandatory audit requirement continues as long as there are more than 100 eligible participants.

- The audit requirement is no longer mandatory when the number of eligible participants decreases below 100.

Video Transcript

4. Auditing Employee Benefit Plans

SURRAN: Maintaining and retaining documentation is one of the most important responsibilities of employee benefit plan fiduciaries. Not only is it beneficial to have the appropriate documentation to support historical plan activities and participant elections regarding investment choices, distribution and requests, it will also prevent confusion and problems down the road. Not to mention that it is also required by the Internal Revenue Service and Department of Labor to support the information reported on Form 5500 filings.

Our own Michael Quinlan looked into the concept of fiduciary responsibility, the best practices companies follow to make sure their plan is running efficiently and in the best interest of its participants, as well as the common mistakes that companies make while administering 401K and other retirement plans. Mike spoke with David Dacey, Practice Leader, Employee Benefit Plan Services Group, WithumSmith+Brown PC.

QUINLAN: Dave, I want to welcome you to the program this month.

DACEY: Well, it's a pleasure to be here, Mike.

QUINLAN: Dave, maybe we can start by telling the viewers what you mean by fiduciary responsibility.

DACEY: Baked within the Employment Retirement Income Security Act, or ERISA, there is a requirement for a plan sponsor who oversees an employee benefit plan to act in a fiduciary responsibility. They have to make decisions that are prudent and that are being made on behalf of the participants.

There's essentially just a responsibility whereby a company can't just form a plan and that's it. They have to oversee the plan and make sure the plan is acting in the best interests of the participants.

QUINLAN: Dave, there seems to be more talk about the concept of fiduciary responsibility in today's world as it relates to 401K plans and other retirement plans. What are the reasons for this development?

DACEY: You know, I think there are a couple of factors.

Number one, several years ago the Department of Labor came out with a formalized database to harness 5500s, called the EFAST2 Database that now makes every 5500, and every associated financial statement for larger plans within that 5500, public information.

So that's out there.

A couple of years ago, in July of 2012, the Department of Labor came out with new regulations related to service provider fee disclosures called Section 408(b)(2).

That required a much more transparent look at the fees that were being charged to plans and probably about five or six years ago, there was a court case called LaRue v. DeWolff which allowed participants to sue fiduciaries for breach of fiduciary responsibility.

If you put those three things together, I think the amount of transparency that's out there for fiduciaries is greater than it's ever been before.

QUINLAN: Dave, you talked about Form 5500 filings being public information. That is to a certain extent a snapshot or a quasi-report card of how a fiduciary is meeting their responsibility. How is that annual filing being scrutinized by the public, and who is doing the scrutinizing?

DACEY: Well, because the 5500 is public information, it's accessible to everybody. So as a couple of examples, the Department of Labor certainly is scrutinizing the form 5500 database. They are looking very, very closely at how the form is being filled out and whether there are any inconsistencies within the form or answers within the form that may cause greater scrutiny or regulatory oversight of a particular plan.

So you have that as a first issue.

The second issue is there's a section within the 5500 called the schedule C, which highlights all of the fees that are actually being paid out by the plan.

With the advent of that earlier pronouncement that I talked about, that section 408(b)(2) and that schedule C, if you put those together, it's causing a lot more price competition and a lot more transparency in the types of fees that are being charged to a plan. So it's really creating a much more level playing field for the plan in terms of the fees that are being charged.

And it's actually working in favor of the plan.

QUINLAN: So at a minimum, Form 5500 and the attached audited financial statements for larger plans has created more transparency for 401K and other retirement plans. But not every retirement plan requires audited financial statements. When exactly are audited financial statements required to be attached to Form 5500?

DACEY: The Department of Labor has a rule that's called the 80-120 rule for a retirement plan, and it could be health and welfare plans too, but let's just focus on the retirement plan aspect of it for a moment.

For a retirement plan, once a plan (as of the beginning of the year) has 121 eligible participants, eligible being the operative word, there is a requirement to have a plan audit, which means that the 5500 has to attach financial information and the actual plan itself requires audited financial statements.

That rule stays in effect, or that requirement stays in effect, until such a time that the number of eligible participants dips below 100. Once that happens, the plan no longer requires audited financial statements. It's considered a small plan.

QUINLAN: So what regulatory controls does the Department of Labor have in place to make sure that large plans comply with the requirements to attach audited financial statements?

DACEY: Well, that's where the world is getting really interesting, Mike.

The 5500 database has a field of information for eligible or number of participants as of the beginning of the year.

So it's really just a matter of putting some software algorithms into the 5500 database to identify any plan that has over 121 eligible participants, or 100 participants if you have met that 121 eligibility requirement in prior years.

Then measure that against whether there's an attached set of financial statements.

If that doesn't occur, the Department of Labor can produce a 100 percent exception list and start knocking on the door of those plans that are not complying with ERISA.

QUINLAN: You mentioned earlier some aspects of Form 5500 that are being scrutinized by the DOL and others. Let's focus on the attached financial statements for a moment. Can you give a few examples of some high-level analysis that can be determined from a quick read of the financial statements?

DACEY: Yes, I can. There are a couple of different examples.

I actually wrote an article on this which we have on our website. But just to get into a couple of examples.

Number one, if the auditor's report has what's called a limited scope audit exception, there are some times I've seen filings that are done where there's certification being done on contributions, distributions, and administrative expenses. You're not allowed to certify those types of things in a limited scope engagement. Limited scope engagements really deal toward certifying just investments.

So that's one example. If a CPA or an auditor of a set of financial statements is certifying the distributions and administrative expenses that calls into question whether they actually understand the context of a limited scope engagement.

Second thing. There's a concept called a partial termination. Partial terminations occur when over 20 percent of a workforce is laid off at a particular point in time. When that event happens, those participants become 100 percent vested in the plan.

So if you think about that, if you looked at a statement of changes in net assets, which is essentially the activities of the plan, and you compare distributions as a percentage of beginning-of-the-year net assets, if that number is over 20 percent, there is a high degree of likelihood that there was a partial termination within a plan.

It certainly begs the question of the plan's sponsor whether that happened or not. In the event it did, the plan would want to make sure that the participants who were affected by that became 100 percent vested and their unvested proceeds weren't erroneously categorized as forfeitures because if that happened, there would be an operational deficiency in the plan.

Then there are other examples, also, but those are probably two of the bigger ones.

QUINLAN: Dave, you talked about whether the audit was a limited scope or a full scope audit. What's the difference between a full scope audit and a limited scope audit?

DACEY: A full scope audit requires the auditor to audit the investment activity and balances within a plan.

A limited scope audit does not. And a limited scope audit is permitted, under law, provided you meet certain conditions.

In terms of the number of financial statements that are filed with Form 5500, the Department of Labor estimates that about 70 percent of the financial statements that are filed with 5500s are limited scope audits.

So there's no audit of investments being done in a limited scope audit. So what exactly is happening and why is that permitted?

Under law, if there is a bank or an insurance company that is certifying the investment activities and balances of a plan, and they actually issue a certification, as long as that certification is acceptable to the auditor, they're permitted not to audit investments essentially, which is the largest balance in a set of financial statements for a plan.

QUINLAN: Dave, so what's actually involved in a full scope audit?

DACEY: Well, again, a limited scope audit is an audit that's performed whereby the trustee of the plan's assets provides the auditor with a certification as to the completeness and accuracy of the investment information that's being certified.

And it doesn't include things like contributions and distributions and administrative expenses. It's strictly investment activities and assets. A full scope audit actually tests those activities and assets.

So as an example, an auditor would send a confirmation out to the investment provider to confirm the balances.

They would look at investment transactions that the net asset values, for which the transactions were being transacted, were the market values at that particular day.

And there are situations where they're not, and there might be adjustments that need to take place as far as that's concerned.

There is a procedure where investment balances, whatever they're being valued at, an auditor would look to independent sources to make sure that the market values are actually what the investment company is using.

There was a court case, probably in the 1980s, I guess; Drexel Burnham was over-valuing assets to get higher fees.

That's just going back from recollection. It's a long time ago, but the Auditing Standards Board reacted to that by verifying investment balances to independent sources.

So those are the types of things; there's just a more robust look at investment activities and balances to make sure that they're appropriate, that they meet the various audit assertions, that they exist, that they're properly valued, and that there are no rights and obligations issues related to those balances.

It's a much more robust look at investments than you would otherwise have if you were to do a limited scope audit where you're essentially accepting a certification from an acceptable party.

QUINLAN: Can you speculate on the legislative rationale as to why an audit with a limited scope claim would be an acceptable opinion to be attached with financial statements filed with Form 5500?

DACEY: The speculation would be there was a lot of lobbying done at the time that the investment houses which were holding the plan's investment assets were heavily regulated to begin with.

So they were in a position to certify the completeness and accuracy of the investment data that they were providing to plan sponsors as part of the plan information.

So with that level of certification, my speculation would be that there was lobbying done at the time that just permitted, in terms of saving costs for the plan, the use of the certification as an alternative to doing the full scope audit procedures for investments.

QUINLAN: Since investments are virtually always the largest asset in a 401K plan and a limited scope audit doesn't include an audit of investments, why would a fiduciary opt for a limited scope audit instead of a full scope audit?

DACEY: I think the reasons are primarily economic, Mike.

Yes, it's less costly to have a limited scope audit done rather than a full scope audit, with the understanding that the investments are being certified by the investment house as to completeness and accuracy.

And both of those things need to be articulated in the certification in order for it to be considered a valid certification for an auditor to utilize in the conduct of their audit. So that's number one.

Number two. If you compare a full scope audit with a limited scope audit, they both cover a very important aspect from the perspective of the Department of Labor; i.e., participant protection.

So there are operating aspects of a plan that actually get tested in a very robust manner during both the limited scope and a full scope audit.

You're getting that done regardless of whether you're opting for the pricier, full scope audit versus the more economical limited scope audit.

QUINLAN: So both limited scope audits and full scope audits alike involve a deeper dive into various operational and financial reporting aspects of the plan. You also mentioned that participant protection is an important aspect to either type of audit. Can you provide some examples of what you are testing?

DACEY: There are several areas.

If you think about what a plan does, a plan receives contributions from a plan sponsor. They can be employer contributions or employee contributions.

And those contributions need to occur in accordance with the contract for the 401K plan, which is called a plan document.

So the plan document will articulate the conditions under which contributions can be made, and the limitations on the amounts that can be made. It will articulate how employer contributions occur. It will articulate aspects such as eligibility; for example, when is a participant eligible to be part of a plan?

There may be loan provisions within the plan document.

There are distribution provisions within the plan document. So anything that really goes into the operations of the plan is articulated in the plan document. So an audit basically tests those types of things.

Another important aspect is whether those deposits are being done on a timely basis because that creates a host of problems if they're not.

QUINLAN: Let's focus on a few of these various operational aspects of the plan and let's start with one example process. Participant 401K withholding deposit timeliness. What are the issues relating to maintaining fiduciary responsibility to this process and what does the typical audit test?

DACEY: Anyone who is a participant in a 401K plan has money withheld from their payroll to deposit into the plan.

The plan has a trust account, an investment account, and the participant has an expectation that those monies are being deposited in as timely a basis as possible.

To the extent that that doesn't happen, the Department of Labor considers that to be a prohibited loan.

So prohibited loans are not a good thing. They're considered prohibited transactions. It's as if the plan's sponsor is utilizing those withheld monies for their own benefit to the detriment of the plan participant.

Audits test that type of thing, so the main aspect of the timeliness of deposit test is to make sure that, once the money is withheld from the participant, it's being deposited for the participant's benefit as soon as possible. To the extent it's not, someone might argue it's a prohibited loan and a prohibited transaction which is illegal.

QUINLAN: How about testing for timeliness of deposits? What does the auditor do?

DACEY: To test timeliness of the deposits, we would look at 401K withholdings from the participant's payroll and compare the date on which that occurred to the date on which the proceeds were actually deposited in the investment trust account on behalf of the participants. That needs to be done in a timely fashion.

Now, what's a timely fashion? Well, that depends. It depends, administratively, on when the plan's sponsor can reasonably segregate the assets, come up with the appropriate administrative processes to get that money into the investment account on behalf of that participant as quickly as possible.

As an auditor, we would look at the timing between when the payroll withholding occurs, and the timing on when it was actually deposited into the investment account. If that doesn't occur in a reasonable timeframe, there's a problem; there's a potential timeliness of deposit issue.

To make that determination, if a plan has a track record of being able to do this in two days and then, all of a sudden, they switch to seven days, well, they've already demonstrated in a trend that they can do it in two days. So doing it in seven days is actually a problem, and it's cause for concern as to whether those deposits were actually done on a timely basis.

If they weren't done on a timely basis, there's financial reporting that needs to occur, and there's 5500 reporting, and there might be DOL scrutiny.

QUINLAN: Let's stay on the topic of contributions. Generally speaking, what are the processes that you are testing?

DACEY: When I think about contributions, I think about the entire cycle related to contributions. You know,

I talked earlier about the concept of eligibility. The plan document will dictate when someone becomes eligible to participate in a plan, and those eligibility provisions need to be in line with ERISA, meaning as an example, maybe 1000 hours worked, and over the age of 21, you're eligible to participate in a plan.

We would test to make sure that the provisions of the plan document were being adhered to and to the extent that they warrant the plan's sponsor isn't operating the plan appropriately, and they may have to make those participants who weren't given the opportunity to participate in a plan whole, because there are certain rules under ERISA that have to be followed in that regard. So that's one example.

A second example would be were the amounts that were withheld the amounts that were actually deposited? So there would be a comparison of withholdings to actual deposits on a participant's behalf. To the extent that's not happening, there's an operational deficiency.

We would look at things like elective deferral percentages if someone changed their percentage during the year.

Did the plan properly comply with that request to change the percentage or was it done in an appropriate manner? Were the employer contributions, if there's a matching or a discretionary contribution, were they done in accordance with the provision of the plan document?

So most of the time, it really comes back to the provisions that are articulated in the plan document, which is really the contract for the plan. Or, is the plan operating the way it's supposed to?

QUINLAN: Let's talk about both participant deposits and contributions. What happens if you find mistakes during the audit?

DACEY: To the extent that the plan is not operating in accordance with the plan document, there's an operational deficiency.

Operational deficiencies could jeopardize the tax status of the plan. That's a real problem, and it doesn't happen very often, but if the plan's tax status were to be jeopardized or removed, any contributions that a plan sponsor made on behalf of the participant, and deducted on their tax return, would be disallowed.

That's a real problem. That could actually cripple a company, to the extent that withholdings from a participant were deposited in a plan, and the participant deducted that on their tax return, they would theoretically be disallowed too.

So there could be crippling consequences to a plan if their tax status were jeopardized. And that's why it's really important to make sure that operational deficiencies get corrected as quickly as possible.

QUINLAN: Dave, if there is an operational deficiency, what do you do?

DACEY: If an operational deficiency occurs, there's one of three alternatives.

You could self-correct, you could go into the voluntary compliance program, or if you were investigated or inspected by the department or by the IRS, you would have what's called the Audit CAP program, where you would enter into a correction program, but you've already been investigated, and the IRS is aware of the problem, so the penalties are much stiffer for that type of program.

So, in terms of severities, self-correction is the most economical thing for a plan to do.

The voluntary compliance program has a fee associated with it based on the number of participants that a plan has, but the nice thing about that is, once you enter into a voluntary compliance program, the IRS will issue a statement to you after the completion of the program, "As long as you do these things, we don't have any other issues related to the operational deficiency."

You don't have that necessarily with self-correction, but it is more economical to do self-correction. So as an example, if we look at timeliness of deposits. If a deposit was deemed to be untimely, the number of days in which it was late, the plan would calculate lost interest related to that untimely deposit. They would make a deposit for the lost interest on behalf of the participants.

They might file excise tax returns to demonstrate to the IRS that that issue occurred, and they would just move on. They've been good citizens. They've restored lost interest and they would move on.

In order to take advantage of self-correction, they need to be in good standing from a tax perspective, meaning there really needs to be what's called a current IRS determination letter or approval letter. Depending on the type of plan document that they have, it goes under different names. But it's essentially an IRS approval letter. That approval letter needs to be in place in order to take advantage of self-correction. If it's not in place, and they decide to do the voluntary compliance, you know, we talked about that.

There's a fee that's paid. There's a course of action that's taken, and if that course of action is provided or complied with, no harm, no foul. You move on with your life. And then, finally, the Audit CAP we talked about that later.

Do the VCP before the IRS comes in to inspect you and they come up with findings, and you're entering into the Audit CAP program. That becomes a lot more costly.

QUINLAN: Dave, can you talk about, from your experience, some of the weaknesses that you've seen in plans?

DACEY: Yes, the biggest weakness that we see, especially with new clients that we bring on board, is the timeliness of deposit issue.

The rule that is written is that the participant withholdings need to be deposited as soon as the funds can be reasonably segregated from general assets, but in no later case than the 15th of the following month.

A lot of plan's sponsors will look at the second part of that, "...in no case later than the 15th of the following month," and they say, "Okay, well, I have until the 15th of the following month to make the deposit."

That's just not accurate. You need to make the deposit as soon as it's reasonably segregable. You can almost think of it as payroll withholdings or payroll tax withholdings or trust fund taxes. It's the same concept, essentially.

As soon as you can segregate the money and get it into the plan, you're supposed to do that.

That's probably the lowest hanging fruit that's out there as it relates to operational deficiencies in a plan. And the Department of Labor actually has a national initiative where they look at that on every inspection that they do of a plan. So that's one example.

There are a host of examples.

The definition of compensation is probably another good example of operational deficiencies that we see.

And, to give you an example, let's say that the plan documents say that, "We're going to base elective deferrals and employer matching contributions based on total compensation."

Well, total compensation can include things like bonuses and overtime, but operationally the plan may not be operating that way. They may be excluding those bonuses. It does happen.

So any time there's a situation where the plan document articulates the way a plan is supposed to operate, and the plan doesn't operate in that manner, there's an operational deficiency that needs to be corrected.

QUINLAN: Dave, what can a company do? What steps can they take to put in place controls to prevent these weaknesses from occurring?

DACEY: There is a good piece of public information out there that the IRS put out.

It's called the IRS 401K Fix-It Guide. What it does is it articulates, in their view, the top ten operational deficiencies that a plan has. It gets into how the error occurs, what to do if you have the error, and how to prevent the error from occurring.

It's actually structured in that way. It's a very, very well-written document, and I would highly recommend it for anybody who wants to get a sense on how to start implementing controls.

The IRS is on record saying that they think the best way to prevent operational deficiencies from occurring is to have good internal controls in place.

So it really does start with internal controls.

So you could look at the IRS 401K Fix-It-Guide. You could look also at our website if you want. You know, I have a video blog. You could take a look at that.

I put examples of internal controls out there. There are plenty of professionals that do the same exact thing. So, you know, in today's information society, there are a lot of sources of information to get really good ways to implement internal controls and document those internal controls for your plan.

But I think a really good starting point is the IRS 401K Fix-It Guide.

QUINLAN: Dave, with respect to employee benefit plans, how important is tone at the top?

DACEY: You know, Mike, in today's world with increased transparency, you know, we talked earlier about the form 5500 database. The amount of scrutiny that's occurring at plan levels, the cottage industries that are cropping up, you know, the amount of lawsuits that are occurring – I mean, you can go on the Department of Labor's database and see lawsuits for fees, you know, every day of the week.

I mean, there are a lot more regulations that are occurring. There have been a lot of court cases, some fairly high profile court cases that are occurring.

With increased transparency on these plans, I think tone at the top and really solid control environments are critical, and if they haven't necessarily received the level of focus that maybe they should have in the past, I think as time progresses, and we have more transparency with respect to these plans, there's only going to be increased scrutiny and increased transparency.

Really having a good tone at the top and having good processes in place and good control environment, and the like is really important to a plan.

QUINLAN: Dave, do you have any closing thoughts for our viewers?

DACEY: Yes, I think increased transparency and scrutiny of plans is critical. If plan sponsors didn't necessarily have a great deal of focus on their plans, they should more now than they have before, because there are a bunch of things that have been occurring.

The 5500 database. I'll give you some examples. The 5500 database, I think, the DOL has done an excellent job in coming up with unique ways of scrutinizing that database to find anomalies and problems that may exist in the U.S. database.

So as an example, one of the things that the Department of Labor is doing right now is they are marrying up the state of domicile of the plan, where the plan is located, with the accounting firm that is performing the audit of the plan.

They marry up those two aspects within the 5500 filing and then, working with state boards of accountancy throughout the United States, they are looking to see if those firms are properly licensed in that particular state.

We've actually been to the beneficiary of a couple of plans where the accountant wasn't even licensed. So that's an example.

A couple of years ago the auditing standards changed where the audit report in 2012, the content of the audit report changed, and the format of the audit report changed.

Well, the Department of Labor wrote an algorithm to look at the 5500 database, and look at the nature of the audit report, looking for certain phrasing that occurred in the audit report. And, to the extent that that phrasing didn't exist, that was an indicator for the Department of Labor that the auditor who was auditing the plan wasn't using the right audit report and may not be current on appropriate auditing standards.

So there's a whole initiative that's occurring where there's a lot greater data mining in Form 5500s, and it's being done both from a regulator's perspective and from a business perspective.

You know there are plenty of service providers who are out there who are taking a really hard look at fees and what's being charged to a plan and are using that to scrutinize.

Now, if you think about it from a fiduciary's perspective, a fiduciary has a responsibility to make sure that the fees that are being charged to a plan are reasonable. So to the extent that's not happening, they face exposure.

So paying mind to these plans is really an important thing to do and having good policies in place, having investment committees and investment policy statements that are actually followed, as opposed to having a policy statement that's not being followed, that could be detrimental to a plan.

But having those policy statements that are being followed, having investment committees in place, having good solid oversight over the operational processes of a plan, those are all important things to do.

And, as these plans get further and further scrutinized, having those ducks in order and having all those processes documented in the conclusions reached from those oversight processes, it's just an important thing to do. It keeps a plan safe and keeps a plan sponsor safe.

QUINLAN: Dave, a lot of great information. Thanks for being here today.

DACEY: Oh, thanks for having me, Mike. I appreciate it.