

Are You Ready?
Preparing for Your First
401(k) Plan Audit





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Introduction

Your company is growing, and so is your 401(k) plan. When a plan reaches a certain size, it is required to be audited by an outside independent accounting firm. What can your company do to prepare for this first audit?

Chances are, this first plan audit will be an eye-opening experience with the auditor taking note of procedures, practices or other matters that could be improved or that raise potential problems that were never considered prior to the audit. Most companies are not prepared for a detailed examination of plan compliance, fiduciary responsibility, internal controls or best practices.

This is a primer for a growing company that may not need a plan audit today, but may need one in the near future; a roadmap of what to consider, what to expect and how to be ready for an upcoming plan audit. You will be more prepared for the questions that will be asked and the requests that will certainly be made during the audit process.

When is a 401(k) plan required to be audited?

Generally, a plan is required to be audited when it has greater than 100 eligible participants on the first day of the plan year (120 if the plan has not been previously audited, 100 every year after). The second criterion is that the plan has assets that are held in a trust. All 401(k) plans are required by law to have assets in trust.

What is an eligible participant?

Eligible participant is defined as anyone who is eligible to participate in the plan, including those employees who have met all eligibility requirements, but are not participating in the plan. It also includes terminated employees who have balances in the plan on the first day of the plan year.

Eligible participants = all eligible active employees + terminated employees with account balances

When is the plan required to be audited?

Audits must be completed seven months after the end of the month the plan year ends, with an option to extend for two-and-a-half months afterwards. For example, if you have a calendar year end plan (December 31), audits must be completed by July 31 of the following year, with an option to extend through October 15.

What does a plan audit entail?

An audit of a plan will look at two major areas:

- **Compliance** – verify the plan is operating in compliance with certain Department of Labor (DOL) and Internal Revenue Service (IRS) regulations as well as with the written form of the plan related documents.
- **Financial reporting** – determines the accuracy of the financial information as reported on the Form 5500 as well as the financial statements (including required disclosures) of the plan.

How can I prepare for a 401(k) plan audit?

You can prepare for your plan audit by reviewing these five areas:

- Document gathering and organization
- Fiduciary responsibility
- Operational compliance
- Internal controls
- Financial reporting

Document Gathering & Organization

One of the first things your independent auditor will request are plan related documents. Plan sponsors may not be familiar with all of these documents or where these are kept within the company's records.

These documents include:

- Executed Plan Document (including executed adoption agreement for prototype or volume submitter plans)
- Current IRS determination or opinion letter for the executed plan document
- Executed amendments to the plan document
- A current and historical Summary Plan Descriptions and Summaries of Material Modifications
- Executed 401(k) Administrative Committee Minutes for the plan (see below on Fiduciary responsibility)
- Executed Board Minutes as they pertain to the plan
- Trust and recordkeeping agreements with plan custodian and recordkeeper
- Copies of prior years' Form 5500 filed with the DOL
- Copies of prior years' audited financial statements (after the plan's first audit, if applicable)
- Copy of the plan's fidelity bond insurance
- Any other agreements or significant correspondence related to the plan

As a best practice, these documents should be easily accessible, organized and current. These documents will also be required if your plan is selected for audit by the DOL.

Fiduciary Responsibility

Sound fiduciary policy and oversight of a plan is the cornerstone of excellent plan internal controls. Many plan sponsors are unfamiliar with the risks associated with being a fiduciary of their company's 401(k) plan and can be held personally liable for breach of their responsibility. Most are not even aware that they themselves are a fiduciary of the plan.

A person is a plan fiduciary if he/she:

- Exercises any discretionary authority or control over plan management
- Exercises any authority or control over plan assets
- Renders, or has any authority or responsibility to render, investment advice for a fee
- Has any discretionary authority or responsibility over plan administration

So how does a fiduciary of a plan act in the interest of the plan participants, as well as protect themselves from liability? Here are some best practices we recommend every plan sponsor implement to ensure the fiduciaries of the plan are acting in the participant's best interest and are performing the duties that they are required by law to perform.

- **Form a 401(k) administrative committee.** This committee should be authorized by the Board of Directors to take fiduciary, compliance and reporting responsibility for the plan. It should be made up of high ranking company officials that also have insight into the operations of the plan. For example, the heads of finance, human resources or benefits as well as in-house legal counsel may be good choices to serve on the committee.
- **Hold regular meetings of the 401(k) administrative committee.** Once the 401(k) administrative committee is formed, it should meet on a regular basis to review investment performance, plan compliance issues and plan reporting issues. A quarterly meeting is usually sufficient in this regard.
- **Take and retain minutes of 401(k) administrative committee meetings.** Minutes should be maintained for all meetings of the committee. Without documentation of actions and decisions made in committee meetings, it is difficult to demonstrate fiduciaries have performed their duties and have acted in the best interest of the participants of the plan.
- **Develop and follow an investment policy.** An investment policy is a documented roadmap of what types of investments will be offered as options in a plan. An investment policy will help the committee to identify which investment options are performing within acceptable benchmarks, as well as which are not performing and should be replaced with similar, better performing investment options.
- **Review administrative fees being charged to the plan for reasonableness.** Many plan sponsors believe administration of a 401(k) plan is "free" (or close to free), because not many checks are written to pay for 401(k) plan recordkeeping services. In reality, all 401(k) plans cost money to administer. Most of the fees are "hidden" within the investment returns of the plan and in turn, paid by the participants that earn those returns. While the perception of this is slowly changing in the industry, if fiduciaries are not aware of what to look for with respect to plan fees, they can be caught by surprise when this information is brought to their attention.

- **Consider employing the services of an outside investment advisor.** The aforementioned tasks can seem overwhelming to a plan sponsor. There are people that can help. Independent investment advisors are professionals who perform some, if not all of the above functions. An independent retirement plan advisor, who is not an employee or representative of a particular service provider or money manager, can help develop a sound investment policy statement for the plan, addressing diversification, tolerable risk levels and fund performance criteria. An independent advisor can be objective in their evaluation of fund performance and the need for change, if appropriate, as well as advising on other fiduciary responsibilities. The advisor may also assist the 401(k) administrative committee in evaluating the reasonableness of plan expenses by benchmarking against similar fund families and other service provider fees.

Operational Compliance

It is easy to set up a 401(k) plan. It is almost as easy to change some of the provisions to accomplish company goals. For example, it is not hard to make the decision to change plan design to allow for automatic enrollment with the intention of increasing plan participation. This is usually where the real problems can start.

If the plan is not being operated in accordance with the plan design (the provisions of the Plan Document), then the plan (and sponsor) have a compliance issue that more likely than not will need to be corrected. There are also IRS and DOL regulations with which a plan must comply.

Below are some of the more common plan errors we see every year, as well as some issues on which regulators are focused. This is not an exhaustive listing, but highlight areas where plan sponsors going through their first audit tend to have the most issues.

- **Review plan eligibility provisions and compare to actual eligibility practices.** Very often there are some employees that are being allowed to participate in the plan that were defined as ineligible in the Plan Document. The opposite is true as well. If a plan has a waiting period to enter or an age limit, more issues can arise. The most common cause of this error is assuming employees eligible for health benefits are also eligible for 401(k) benefits and vice versa.

Reading carefully through the eligibility provisions of your company's Plan Document and comparing these to what is being done in practice can uncover a number of possible compliance issues. Examples of these can include:

- Ineligible classes of employees allowed to participate
 - Eligible classes of employees prevented from participation
 - Employees allowed to participate in the plan early (waiting period or age limit not adhered to)
 - Employees not automatically enrolled on time
- **Review the plan's "Definition of Compensation" and compare to actual payroll procedures.** The plan's definition of compensation sets the types of compensation that are eligible for 401(k) plan deferral withholdings. For example, a definition of compensation in a Plan Document may read "all compensation reported for W2 purposes." In this case, any salaries, wages, bonuses, commissions, etc. would be eligible for the calculation of 401(k) withholdings, while items like moving expense allowance or deferred compensation would not. Errors often occur while setting up the payroll system for 401(k) deferrals, caused by unclear wording regarding eligible pay types.

There are so many errors made in this area that auditors and regulators alike focus on it. It's worth noting that this is a DOL hot button issue. Understanding your eligible compensation provisions will help you to avoid costly and time consuming corrections.

- **Timely deposit of participant deferrals.** The timely deposit of participant deferrals with the plan custodian (including participant loan repayments) is the most significant issue for independent auditors and the DOL. Provisions or guidelines for these transactions cannot be found in the Plan Document; this is a DOL regulation designed to protect the participants of the plan from unauthorized use of their money by the sponsor.

For large plans (those with over 100 participants), deposits of participant contributions must be segregated from the general assets of the sponsor (that is, transferred out of the company's cash account) as soon as administratively feasible but no later than the 15th business day following the month end of the applicable pay date.

However, the DOL doesn't consider this a safe harbor. For example, if a sponsor demonstrates that deposits can be made three business days after the pay date on a regular basis, then any deposits in excess of that three business days limit may be considered to be late, as well as classified as a prohibited transaction by the DOL. Late deposits are required to be corrected by depositing lost earnings into the affected participants' accounts and making compliance filings. While the actual cost of lost earnings and excise taxes that may need to be paid can be very minimal, the cost of professional fees to assist in preparing the correction can be very costly.

How can a sponsor avoid late deposits? The best option is to set a maximum day policy for contribution transfers and carefully monitor the results of these transfers being made. For example, a sponsor may set the maximum number of days for cash transfer at five business days after the pay date. Any transfers of participant contributions or loan repayments that are made after the fifth business day following the pay date would need to be considered as late and corrected as such. If a contribution exceeded five business days and there was an event that made it administratively impossible to contribute within the policy, (such as a payroll system crash or rejected wires to the custodian that took time to resolve), then make sure these events are documented in the wire packages along with an explanation as to why these contributions were not considered to be late, even though they were out of policy. Keep in mind that vacations, company holidays or other time off are not considered valid reasons for deposits which are out of policy. A back up plan should be contemplated in advance and executed during those times when the primary person responsible for transmitting contributions is out of the office.

As with any good policy, setting the policy is easy – following it is the hard part. Setting a policy of five business days and then not correcting a deposit that took seven business days because it “wasn't that late” is probably worse than not having a policy at all. This policy would also need to apply to special payroll runs outside of the normal pay cycle or manual check runs. If deferrals or withholdings are made, they need to be monitored under the policy and corrected accordingly if late deposits occur.

For plans with less than 100 participants (small plans), there is good news. The DOL has ruled that participant contributions deposited within seven business days are not late. Once there are over 100 participants in your plan, the large plan rules apply.

These cash transfers can also be the source of other internal control related opportunities for error or fraud in plan administration. This process involves large amounts of cash being transferred from the sponsor to the plan custodian, thus controls over wire transfer authorization should be considered. As a best practice, all transfers to the plan should be appropriately reviewed, matched to supporting payroll records and approved prior to execution. In some cases, payroll records may require small adjustments to reflect the actual amount wired. These adjustments should be clearly indicated in and retained with the wire support. This will eliminate time consuming research in the future should this sort of wire be reviewed as part of an audit (by an audit firm or government agency).

Internal Controls

For public company sponsors, “internal controls” have become common but sometimes dreaded words, usually associated with Sarbanes-Oxley compliance. For many plan sponsors, controls over the plan are not often really given substantive attention, especially in a company of 100 or less employees. Most sponsors feel that if an outside custodian and recordkeeper is employed, then there isn’t any opportunity for fraud or errors.

In our experience, even with the best third party administrators (TPAs), there are plenty of opportunities for errors to occur if proper authorization and review controls are not implemented by the sponsor. Where there is lack of oversight, there is the opportunity to commit fraud.

Most TPA organizations have what is called a SSAE 16 (formerly known as a SAS 70) report. This is a special audit report that describes the control structure at the TPA. Most SSAE 16 reports also detail the testing and results of the effectiveness of the control structure. These reports can be used by sponsors and auditors to gain an understanding of the controls at the TPA and by extension, the plans they administer. In most cases, these reports will confirm what the plan sponsor already knows: the controls at the TPA are adequate and can be relied upon to process plan information accurately.

However, there is a small catch with SSAE 16 reports. There is a section in each report that details “user controls.” These are the controls that are expected to be in place at the plan sponsor to be able to rely on the controls of the TPA. These user control listings can be lengthy, however they usually boil down to a few key points. As a best practice, obtain a copy of this report on an annual basis and review it. If you have any questions about the report, contact your service representative.

The key user control areas that are often indicated in SSAE 16 reports are summarized below.

- **Review participant data provided to the plan’s TPA on a regular basis.** The participant data provided to the TPA is a critical part of plan administration. This information includes participant names, social security numbers, hire dates, termination dates, birth dates and other important demographic information that the provider uses on a daily basis to process the transactions of the plan. If this information is incorrect, then the TPA will be operating using bad information. For example, if hire and termination dates are inaccurate, then distributions may be authorized to ineligible participants and improper vesting percentages may be applied to those distributions, causing a participant to forfeit more or less money than they were actually entitled to under the terms of the Plan Document.

Historically, this information was provided via hardcopy forms. If a participant wished to enroll in the plan or change an election, they would fill out a form that indicated their direction and route this to Human Resources. The changes on this form would be copied and sent to the provider to enter the new participant or execute the indicated changes. Human Resources would file the original away for their records. The TPA would also have a copy of the form on hand, which meant that if a form was lost there would be a backup copy. Human Resources could also check the changes against their form records on a regular basis to monitor the accuracy of new participant data or direction changes by the TPA.

The modern 401(k) plan doesn’t use forms to enroll new participants or make election changes. Information about employees is summarized by the sponsor in a “feedback” file. Usually this feedback file is generated automatically from the human resources database or from payroll

records. This file is sent to the TPA, who uploads the information into their recordkeeping system (also an automatic process). This will update the participant profiles on the recordkeeping system, enter new hires and indicate that they can sign up for the plan (after satisfying the necessary waiting period for the plan), mark terminated employees as eligible to receive benefits, etc. After this is complete, the participant indicates their own elections to the TPA (enrolling in the plan, changing deferral rates, making investment elections, requesting distributions and loans), usually using an online interface.

Since participant eligibility to make contributions to the plan or receive a distribution is based almost completely on the data that is provided to the TPA, it is critical this information is accurate. As a best practice, the regular feedback files sent to the providers should be checked for accuracy and a record (such as a sign off or an email record indicating it has been reviewed and approved) retained to show the review is being performed on a regular basis. To take this a step further, changes that should have been made on the provider's recordkeeping system based on information on the feedback file can also be checked to ensure that the appropriate changes were made after the file has been sent.

- **Review incoming information coming back from the plan's TPA.** Similar to the outgoing feedback file, there is an incoming feedback file that is equally critical to the operations of the plan.

First, another history lesson: in the hardcopy 401(k) plan world, changes to deferral rates were made on a form and given to Human Resources or Payroll. These changes were entered directly into the payroll system and the form filed away for the company's records. The accuracy of the deferral rate elections in the payroll system could be checked by comparing it to the form on file and sign offs indicating that this was checked could be made on the form, also becoming part of the company's records.

In today's paperless, online directed 401(k) plan world, these changes are done through feedback files similar to the outgoing files which contain participant data, except these originate with the TPA and are sent to the plan sponsor. When a participant wants to change their deferral rate election, (which could also be to start contributing for the first time), they log onto their online account and indicate what deferral rate they would like to use. The changes to this information for an entire plan are summarized on a regular basis, usually weekly, by the TPA into a feedback file which is sent to the sponsor. This feedback file is uploaded into the payroll system at the plan sponsor, updating the withholdings that are made from participants' pay for the next pay date.

The issue here is executing participant elections accurately and in a timely manner. If elections are not entered into the payroll system correctly, then incorrect withholdings will be made from pay, or in the case of a first time enrollee, not at all.

The corrections associated with these errors are costly to a sponsor. Simply "catching up" a participant by withholding a larger sum from a future pay check is not an acceptable option. The sponsor is responsible for funding at least a portion of the contributions the participant would have made if their election had been correctly made. In addition, any lost earnings the participant would have made on those contributions must also be made up by the sponsor. If a participant elected to stop contributing to a plan and this election was not reflected in payroll, then that participant would need to be refunded their contribution from the plan and any earnings and match forfeited. Whatever the issue, these corrections may require legal help, can be costly and take time.

To help ensure this doesn't happen, deferral rate changes as entered in the payroll should be checked against the feedback file after the upload is complete. If the upload into payroll is manual, then the changes should be reviewed by another employee against the feedback file to verify that all of the changes were entered correctly. To demonstrate that this verification is being done on a regular basis, notations can be made on the feedback files after the upload and review is complete, indicating who uploaded the file, as well as who reviewed the upload and when. These files should be retained, either in soft or hard copy to cross reference against historical payroll information should a discrepancy arise in the future.

- **Review of plan reporting.** On a regular basis, usually quarterly, the plan's TPA will provide reports detailing the transactions of the plan to the sponsor. These reports will include the investment balances of the plan, as well as the related investment earnings for the quarter. In our experience, the investment information is usually reviewed by the fiduciary committee on a regular basis and the rest of the report is ignored.

Other information included in the report may include the contributions received during the period, the distributions and loans issued and who they were issued to and the fees paid from plan assets for the period. These transactions should be reviewed to ensure that there are no obvious errors in transactions that were processed during the period. For example, if a termination distribution was issued to an active participant, that transaction should be investigated. If your plan has an employer contribution and a vesting schedule, distributions should be reviewed on a regular basis to ensure that proper vesting was granted to participants and the correct amounts forfeited.

Financial Reporting

The final area that will be new to you when you embark on your first audit will be financial reporting for the plan. You probably are familiar with the Form 5500 for the plan, as this is filed for small plans as well. However, once you are considered a large plan and require an audit, additional financial reporting is required.

- The Form 5500 requires a Schedule H to be attached in lieu of a Schedule I or a Form 5500-SF (short form). The Schedule H requires more information to be reported than a Schedule I or 5500-SF. In addition, it is the auditor's responsibility to make sure the information on the Schedule H is consistent with the audited financial statements.
- Audited financial statements are required to be attached to the Form 5500 when filed. These financial statements are required to be prepared in accordance with U.S. Generally Accepted Accounting Principles. For 401(k) plans, the accounting, presentation and disclosure requirements for defined contribution plans is detailed under the Financial Accounting Standards Board (FASB) Accounting Standards Codification 962 (ASC 962) – *Plan Accounting—Defined Contribution Plans*. These are industry specific accounting and reporting standards, so general financial accounting standards usually don't apply to plan accounting. For example, there is no balance sheet or income statement (in the traditional sense) in benefit plan reporting, and no equity or cash flow statements. Plan assets and liabilities are reported using a net asset approach, focusing on the assets that are available for plan benefits. The changes in these assets and liabilities are also reported, which could be compared to a traditional income statement, however the significant line items usually seen on an income statement are not the same for a plan's financial statements. When selecting an auditor for a first year audit, be sure to gauge their expertise with benefit plan accounting. An experienced benefit plan auditor can help to educate you on the reporting requirements, as well as assist in the preparation of plan financial statements filed with the 5500.

Related to these financial statements, there are a few areas that have been in the forefront of plan accounting in the recent past that you may want to become familiar with to ensure that you are taking the proper responsibility with respect to financial reporting for the plan:

- **Fair value accounting and disclosures.** Investments held by the plan are generally required to be accounted for at fair value. Fair value accounting standards under ASC 820 have been at the forefront of accounting standards changes in the past three years. In general, the revised fair value standards require that stated fair value represent the estimated "exit price" for an asset.

The change in the definition of fair value did not have much of an effect on valuation of investments in most 401(k) plans, as most holdings were in easy to value mutual funds or similar instruments. The real work is related to the disclosures associated with the standard, which require each investment held by the plan be classified by the inputs used to value (fair value "level") and by investment class (the type of investment held including general investment strategy, industry, vintage, etc.) Additional disclosures have been added every year since the standard was originally put into effect in 2008, which have helped to "improve" their usefulness. These "improvements" have added additional disclosures for certain valuation inputs and specific types of investments.

To be ready for your first audit and the questions that will arise related to this standard, be aware of what your plan actually holds as investment options, how they are valued and what objectives are being achieved by these investments. This will help you to prepare and/or review the financial statements that you will be responsible for and understand the disclosures required to be made in the financial statements.

- **“Stable value” funds.** These funds are very popular in 401(k) plans these days and, to most participants and plan sponsors, look and behave very much like money market funds. A stable value fund must satisfy some criteria to be considered “fully benefit-responsive” and qualify for the specialized reporting described in this bullet point. Most stable value funds satisfy these criteria by design. Not all plans have these funds, but if you do you should understand how they operate, how they are valued and the specialized reporting associated with them.

Participants who make contributions into these funds receive interest at a stated guaranteed crediting rate. The “principal” in these funds will not lose value, hence the name “stable value fund.” The value of the amount a participant would receive at any time under these investments is called the contract value.

The real trick is what happens behind the scenes with these investments. The money invested by participants in these funds is used by the investment managers to invest in underlying investment vehicles, usually fixed income investment contracts that will provide the returns guaranteed to the participants. In the event the underlying funds lose value the guaranteed amounts are not available to “cash out” participants, the fund is “wrapped” by an insurance policy which effectively makes up the difference. The value of the underlying investments of the fund is considered the fair value.

There are two values that are relevant to the financial reporting of a plan that invests in stable value funds: 1) fair value, which is represented by the value of the underlying investments of the fund and 2) contract value, the amount that will be paid out to participants. Fair value means very little to the participants of the plan, as they will receive their benefits at the contract value. Benefit plan accounting requires that both the fair and contract value be reported on the face of the statement of net assets available for benefits, as well as some specialized and potentially lengthy disclosures made describing the investment and how it operates. These reporting and disclosure standards are described within ASC 962.

Closing Thoughts

We frequently work with 401(k) plans undergoing their first required audit, and find that many of the plan sponsors are not aware of all the requirements to get this audit completed and filed. You've taken the first step by reviewing this guide and learning more about the process. If you currently have a small plan but anticipate growing to large plan status, we recommend you start addressing these requirements in the years leading up to the first audit. The more prepared your company is when the audit starts, the more time and resource efficient both your company personnel and the independent auditor can be.

About Mohler, Nixon & Williams

When it's time for your employee benefit plan audit, better bring in the specialists to get the job done right. Mohler, Nixon & Williams (MNW) delivers more benefit plan audits than any other firm in the Silicon Valley and Bay Area. Our ERISA team is by far the largest team dedicated to performing employee benefit audits. Over the past 25 years our expert team has mastered the requirements of benefit plan audits and can efficiently provide services with less hassle.

For more information, please contact Mohler, Nixon & Williams at:

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