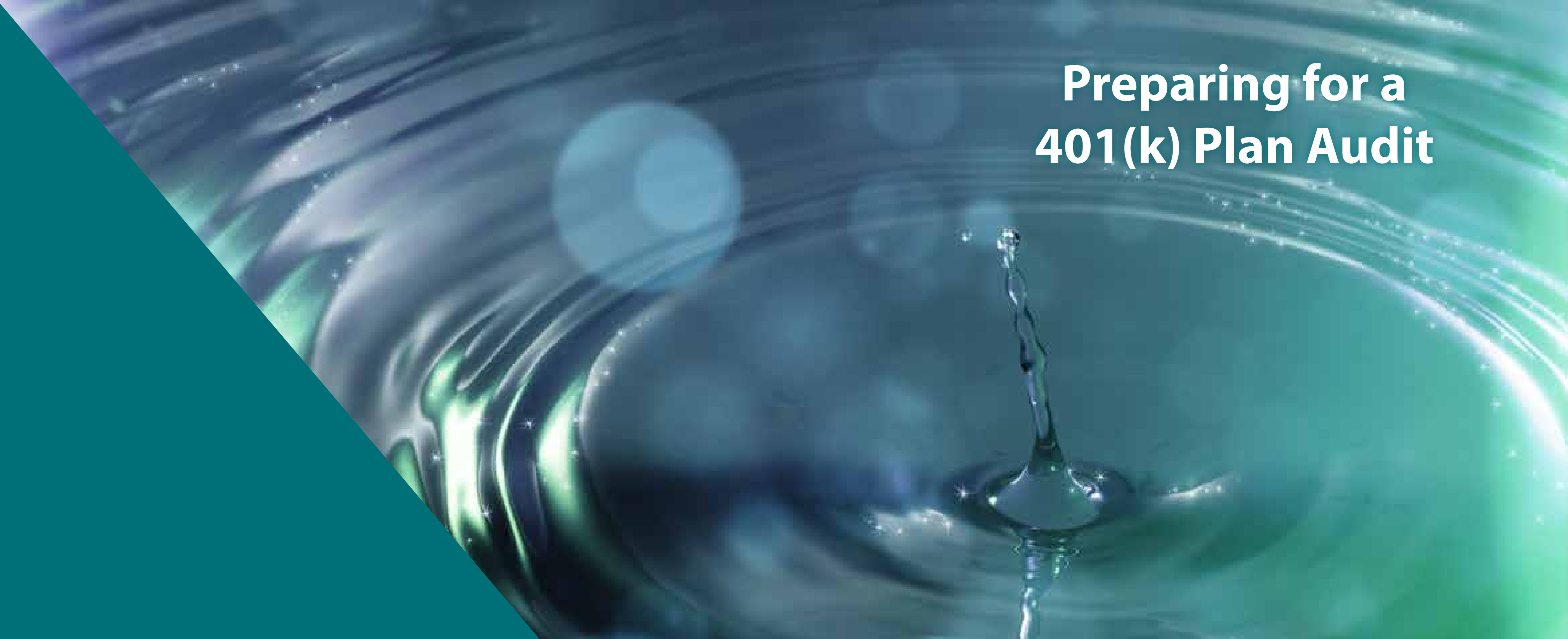
Preparing for a 401(k) Plan Audit



BodinePerry
Certified Public Accountants & Advisors

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OVERVIEW

When a 401(k) Plan Audit is Required

A plan must be audited when it has more than 100 eligible participants on the first day of the plan year, or 120 if the plan hasn't been previously audited, and 100 participants every year thereafter.

Audits need to be completed within seven months after the plan year ends. There is an option to extend the deadline for another two and one half months. For example, if you have a calendar year-end plan (December 31), audits must be completed by July 31, or October 15 if an extension has been filed.

Defining Eligible Participants

Any individual who is eligible to participate in your company's 401(k) plan. This includes all employees who meet eligibility requirements, but have chosen not to participate in the plan. It also includes employees who have separated from the company, but maintain a balance in the plan on the first day of the plan year.

What an Audit Involves

A 401(k) plan audit will review two major areas:

1. Compliance - to verify the plan is operating in compliance with certain Department of Labor (DOL) and IRS regulations as well as with plan-related documents.

2. Financial Reporting - to determine the accuracy of the financial information as reported on Form 5500 and plan financial statements, including required disclosures.

Advance PREPARATION

The more prepared your company is when the audit begins, the more efficient your company, personnel, and the independent auditor can be. We recommend focusing on these five areas:

Document GATHERING & ORGANIZATION

Your independent auditor will request plan-related documents. All necessary documents should be easily accessible, organized and current. These documents will also be required if your plan is selected for audit by the Department of Labor.

Necessary Documents

1. Executed plan document, including executed adoption agreement for prototype or volume submitter plans
2. Current IRS determination or opinion letter for the executed plan document
3. Executed amendments to the plan document
4. Current and historical summary plan descriptions and summaries of material modifications
5. Executed 401(k) administrative committee minutes for the plan
6. Executed board minutes as they pertain to the plan
7. Trust and record-keeping agreements with plan custodian and record keeper
8. Copies of prior years' Form 5500 filed with the DOL
9. Copies of prior years' audited financial statements—after the plan's first audit, if applicable
10. Copy of the plan's fidelity bond insurance
11. Any other agreements or significant correspondence related to the plan

Fiduciary RESPONSIBILITY

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

A person is a plan fiduciary if he or 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

BEST PRACTICES

Operational COMPLIANCE

It is fairly easy to set up a 401(k) plan, and change some of the provisions to accomplish company goals, such as allowing for automatic enrollment with the intention of increasing plan participation. This is often where problems usually occur.

If the plan is not operating in accordance with the provisions of the plan document, then the plan and the sponsor have a compliance issue that will likely need to be rectified. The plan will also need to comply with IRS and DOL regulations.

COMMON COMPLIANCE ERRORS

Not Reviewing Plan Eligibility Provisions and Measuring Against Actual Practices

Often, there are employees allowed to participate in the plan that were defined as ineligible in the plan document and vice versa. If a plan has a waiting period or an age limit, issues may arise. The most common cause of these errors is assuming employees eligible for health benefits are also eligible for 401(k) benefits.

Reading carefully through the eligibility provisions of your company's plan document and comparing these to what is actually being done can uncover a number of possible compliance issues.

COMMON ELIGIBILITY ISSUES:

- Ineligible classes of employees are allowed to participate.
- Eligible classes of employees are prevented from participating.
- Employees are allowed to participate in the plan too early - so the waiting period or age limit isn't adhered to.
- Employees are not automatically enrolled on-time.

Not Reviewing the Plan's Definition of Compensation and Comparing 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, the definition in a plan document may read, "all compensation reported for W-2 purposes." In this case, all salaries, wages, bonuses, and commissions would be eligible for 401(k) withholdings, while items such as moving expenses and deferred compensation wouldn't. Errors, which often occur while setting up the payroll system for 401(k) deferrals, are caused by unclear wording regarding eligible pay types.

There are so many of these errors that both auditors and regulators focus on it, and it's become a hot-button issue for the DOL. Understanding your eligible compensation provisions will help you avoid costly and time-consuming corrections.

Not Depositing Participant Deferrals in a Timely Fashion

The timely deposit of participant deferrals and participant loan repayments with the plan custodian is the most significant issue for independent auditors and the DOL. Provisions or guidelines for these transactions can't be found in the plan document; the DOL has created regulations designed to protect plan participants from unauthorized use of their money by the plan sponsor.

For plans with more than 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 15 business days following the month-end of the applicable pay date.

This is not considered a safe harbor by the DOL. 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 three business days may be considered late and 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.

So 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. Any transfers of participant contributions or loan repayments after the maximum day following the pay date would need to be considered late and corrected as such. If there was an event that made it administratively impossible to contribute within the window, such as a payroll system crash or rejected wires to the custodian that took time to resolve, 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. Vacations, company holidays, and other time off are not valid reasons for out-of-policy deposits. A backup plan should be prepared in advance and executed during those times. While setting a policy is easy, following it is difficult. This policy also applies 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 fewer than 100 participants, there's good news. The DOL has ruled that participant contributions deposited within seven business days aren't 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, making controls over wire transfer authorization important.

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, whether by an audit firm or government agency.

Internal CONTROLS

For many plan sponsors, internal controls over the plan aren't often given adequate attention, especially in a company of 100 or fewer employees. Most sponsors feel that if an outside custodian and record keeper are employed, then there isn't any opportunity for fraud or errors.

We have found, even with the best third-party administrators, there is plenty of room for errors to occur if the sponsor doesn't implement proper authorization and review controls. Where there is lack of oversight, there is also the opportunity to commit fraud.

Most third-party administrators have what's called a Service Organization Control report. This is a special audit report that describes the control structure at the third-party administrator and will 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 their controls and, by extension, the plans they administer. In most cases, these reports will likely confirm the controls are adequate and can be relied upon to process plan information accurately.

As a rule, you should obtain and review a copy of this report annually. We encourage you to look for the section in each report that details user controls. These are the controls that are expected to be put in place by a plan sponsor so it can rely on the third party auditor's controls. These user control listings can be long, but usually contain to a few key points. If you have any questions about the report, contact your service representative.

BEST PRACTICES

- Regularly Review Participant Data Given To Third Party Administrator
- Review Information Coming From The Third Party Administrator
- Review Transactions on Quarterly Plan Reporting

Financial REPORTING

Form 5500

You are likely familiar with the Form 5500 for the plan, which is filed for both small and large plans. However, once you are considered a large plan and require an audit, additional financial reporting is required.

Form 5500-SF (Short Form)

Usually used before a plan becomes a large plan.

Schedule H

For a large plan information to be reported. In addition, it's the auditor's responsibility to make sure the information on the Schedule H is consistent with the audited financial statements.

Audited Financial Statements

Prepared in accordance with generally accepted accounting principles (GAAP) in the United States, are required to be attached to Form 5500 when filed. For 401(k) plans, the accounting, presentation, and disclosure requirements for defined contribution plans are detailed under the Financial Accounting Standards Board Accounting Standards Codification (ASC) 962, Plan Accounting—Defined Contribution Plans. These are industry-specific accounting and reporting standards for plan accounting.

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.

Fair Value Accounting and Disclosures

Investments held by the plan are generally required to be accounted for at fair value. In general, the fair value standards under ASC 820 require that stated fair value represent the estimated "exit price" for an asset, particularly investments held by a plan.

The provisions of ASC 820 focus on the disclosures, which require each investment held by the plan to be classified by the inputs used to value it (the fair value level) and its investment class.

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

Fully Benefit-Responsive Investment Contracts

These investments are very popular in 401(k) plans and, to most participants and plan sponsors, look and behave very much like money market funds. A fully benefit-responsive investment contract must satisfy some criteria to be considered "fully benefit responsive" and qualify for the specialized reporting described below. Not all plans have these investments, but if yours does you should understand how they operate, how they are valued, and the specialized reporting associated with them.

Participants who make contributions into these investments receive interest at a stated guaranteed crediting rate. The principal in these investments will not lose value. The value of the amount a participant would receive at any time under these investments is called the contract value. Recent accounting pronouncements have made clear that if an investment contract is considered to be fully benefit-responsive, then it should be presented at contract value instead of fair value like other investments. They also require some specialized and potentially lengthy disclosures describing the investment and how it operates. These reporting and disclosure standards are described in ASC 962.

Next STEPS

When selecting an auditor for a first-year audit, be sure to choose a reputable firm with expertise in employee benefit plan audits. An experienced benefit plan auditor can help educate you on the reporting requirements and in the preparation of plan financial statements filed with Form 5500.

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 begins, the more time and resource efficient both your company and the auditor can be.

Learn more at **BodinePerry.com**.

"We frequently work with 401(k) plans undergoing their first required audit. Many plan sponsors are not often aware of all the necessary requirements in filing. Our experienced auditing team is here to help make the audit experience as seamless as possible."

Bruce E. Flyak, CPA, CFE
Partner

About

BodinePerry

Certified Public Accountants & Advisors

Bodine Perry is a growing professional services firm with offices located in Ohio, Pennsylvania, and Florida. Founded in 2002, Bodine Perry now employs over 150 professionals with a wide range of experience and skills, providing services to a variety of industries.

Our primary objective is quality service. To help us meet this objective, each of our valued clients works directly with a partner or manager of the firm whose focus is to ensure the needs of the client are met, on-time, and with the highest-quality engagement team.

Bodine Perry is a member of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center, the Ohio Society of CPAs, the Pennsylvania Institute of CPAs, the Florida Institute of CPAs, the International Foundation of Employee Benefit Plans, and Allinial Global firm association. To enable all Bodine Perry professionals to stay abreast of changes affecting our clients and our profession, our team participates in comprehensive continuing education courses and subscribes to numerous professional publications and resources.

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Canfield, OH
330.702.8100

Columbus, OH
614.431.1040

Fort Myers, FL
239.489.4443

Naples, FL
239.262.2279

Orange Park, FL
904.269.7077

Pittsburgh, PA
412.571.0500

Zephyrhills, FL
813.788.2155