

Preparing for your first 401(k) plan audit





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Introduction

Your company is growing, and so is your 401(k) plan. But when a plan reaches a certain size, it's required to be audited by an independent accounting firm. Will you be ready?

Chances are, your first plan audit will be an eye-opening experience—the auditor may take note of procedures, practices, or other matters that raise potential problems or could be improved. Indeed, most companies aren't prepared for a detailed examination of plan compliance, fiduciary responsibility, internal controls, and best practices.

This guide is for growing companies that may not need a plan audit today but may need one in the near future. It's a road map of what to consider, what to expect, and how to prepare for an upcoming plan audit. After reviewing it, you'll be better able to answer the questions and respond to the requests that will be made during the audit process.

Plan Basics

When Does a 401(k) Plan Need Auditing?

Generally, 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 every year after.

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

Who's an Eligible Participant?

This is anyone eligible to participate in the plan, including employees who've met all eligibility requirements but aren't participating in the plan. It also includes terminated employees who have balances in the plan on the first day of the plan year.

What Does an Audit Involve?

An audit will look at two major areas:

- Compliance—to verify the plan is operating in compliance with certain Department of Labor (DOL) and IRS regulations as well as with the plan-related documents
- Financial reporting—to determine the accuracy of the financial information as reported on Form 5500 and plan financial statements, including required disclosures

How Can I Prepare?

The more prepared your company is when an audit starts, the more time and resource efficient your company, personnel, and the independent auditor can be. We recommend focusing on the following five areas, which are all discussed in this guide:

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



Document Gathering and Organization

Among the first things your independent auditor will request are plan-related documents.

As a best practice, these documents should be easily accessible, organized, and current. They'll also be required if your plan is selected for audit by the DOL. Plan sponsors may not be familiar with all these documents or where they are kept within the company's records.

Necessary Documents

- 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
- Current and historical summary plan descriptions and summaries of material modifications
- Executed 401(k) administrative committee minutes for the plan
- 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

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 that they can be held personally liable for a breach of their responsibility. Most aren't even aware that they're a fiduciary of the plan.

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

So how do plan fiduciaries act in the interest of plan participants while protecting themselves from liability? We recommend plan sponsors implement the following best practices to help ensure the fiduciaries of the plan are acting in the participants' best interest and are performing the duties required by law.

1: Form a 401(k) Administrative Committee

The board of directors should authorize this committee to take fiduciary, compliance, and reporting responsibility for the plan. It should be composed of senior-level company officials that have insight into the operations of the plan. This could include the heads of finance, human resources, and benefits as well as in-house legal counsel.

2: Hold Regular Community Meetings

Once the 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.

3: Take and Retain Committee Minutes

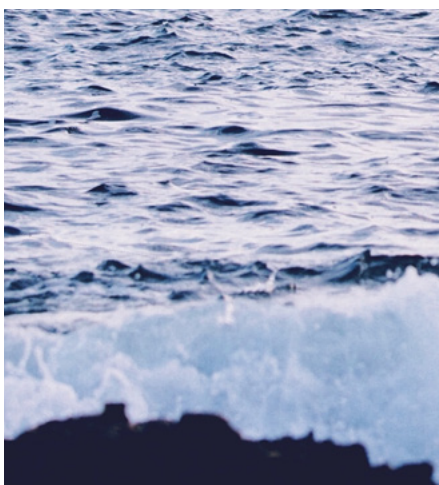
Minutes should be maintained for all meetings. Without documentation, it's difficult to demonstrate that fiduciaries have performed their duties and have acted in the best interest of the participants of the plan.

4: Develop and Follow an Investment Policy

An investment policy is a road map documenting which types of investments will be offered as options in a plan. An investment policy will help the committee identify which options are performing within acceptable benchmarks and which should be replaced with similar, better performing investment options.

5: Review Administrative Fees Being Charged to the Plan for Reasonableness

Many plan sponsors believe the administration of a 401(k) plan is free, or close to free, because they're not writing many checks for plan recordkeeping services. In reality, all 401(k) plans cost money to administer, and most of the fees are hidden within the investment returns of the plan and are, in turn, paid by the participants who earn those returns.



6: Consider an Outside Investment Advisor

Plan sponsors overwhelmed by these tasks can employ the help of independent investment advisors—professionals who can perform some, if not all, of the above functions.

Independent advisors—not employees or representatives 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. They can be objective in their evaluation of fund performances and the need for change, and they can advise on other fiduciary responsibilities. They 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's easy to set up a 401(k) plan, and it's almost as easy to change some of the provisions to accomplish company goals, such as allowing for automatic enrollment with the intention of increasing plan participation. This, however, is usually where the real problems start.

If the plan isn't being operated 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 corrected. The plan will need to comply with IRS and DOL regulations as well.

Common Plan Errors

Below are some of the more common plan errors, particularly for plan sponsors going through their first audits. These are also areas that regulators are often focused on.

Not Reviewing Plan Eligibility Provisions and Comparing them to Actual Practices

Often, there are employees allowed to participate in the plan that were defined as ineligible in the plan document. The opposite is also true. If a plan has a waiting period or an age limit, more issues can arise.

The most common cause of these errors 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's being done in practice can uncover a number of possible compliance issues.

FREQUENT 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 aren't automatically enrolled on time

Not Reviewing the Plan's Definition of Compensation and Comparing It 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 Manner

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 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 15 business days following the month-end of the applicable pay date.

The DOL doesn’t consider this a safe harbor. If a sponsor demonstrates that deposits can be made three business days after the pay date on a regular basis, for example, 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. A sponsor may set the maximum number of days for cash transfers at five business days after the pay date, for example. Any transfers of participant contributions or loan repayments after the fifth business day following the pay date would need to be considered 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 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. Keep in mind that vacations, company holidays, and other time off aren’t considered valid reasons for out-of-policy deposits. A backup plan should be contemplated in advance and executed during those times when the primary person responsible for transmitting contributions is out of the office.

While setting a 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 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 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 aren't often given substantive attention, especially in a company of 100 or fewer employees. Most sponsors feel that if an outside custodian and recordkeeper are 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 the sponsor doesn't implement proper authorization and review controls. Where there's lack of oversight, there's the opportunity to commit fraud.

Most TPA organizations have what's called a SOC 1 (Service Organization Control) report. This is a special audit report that describes the control structure at the TPA. Most SOC 1 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's a small catch with SOC 1 reports. There's a 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 TPA's controls. 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.





KEY CONTROLS: BEST PRACTICES

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 he or she was actually entitled to under the terms of the plan document.

Historically, this information was provided via hard-copy forms. If a participant wished to enroll in the plan or change an election, he or she would fill out a form and route it 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 its records. The TPA would also have a copy of the form on hand, which meant that if a form were lost there would be a backup copy. Human Resources could also check the changes against its 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 its 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), and mark terminated employees as eligible to receive benefits. After this is complete, participants indicate their elections to the TPA (enrolling in the plan, changing deferral rates, making investment elections, requesting distributions and loans), usually using an online interface.

Because participant eligibility to make contributions to the plan or receive a distribution is based almost completely on the data provided to the TPA, it's 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 e-mail indicating it has been reviewed and approved) should be 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

Review Incoming Information 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.

In the hard-copy 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 was 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, which would also become 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 that contain participant data, except these originate with the TPA and are sent to the plan sponsor. When participants want to change their deferral rate election or start contributing for the first

time, they would log on to their online account and indicate what deferral rate they would like to use. The changes for an entire plan are summarized on a regular basis, usually weekly, by the TPA into a feedback file, which is uploaded into the plan sponsor's payroll system. This information updates 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 aren't entered into the payroll system correctly, then incorrect withholdings will be made, or—in the case of a first-time enrollee—no withholdings could be made.

Correcting these errors can be costly to a sponsor. Simply "catching up" a participant by withholding a larger sum from a future paycheck isn't an acceptable option. The sponsor is responsible for funding at least a portion of the contributions the participant would've made if his or her election had been correctly made. In addition, the sponsor must also make up any lost earnings the participant would've made on those

contributions. If a participant elected to stop contributing to a plan and this election wasn't reflected in payroll, then that participant would need to be refunded his or her contribution from the plan and any earnings and match contributions would be forfeited. Whatever the issue, these corrections may require legal help, and they can be both costly.

To help ensure this doesn't happen, check the deferral rate changes in the payroll against the feedback file after the upload is complete. If the upload is manual, then another employee should review the changes against the feedback file to verify that they were all 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 and who reviewed the upload and when. These files should be retained, either in soft- or hard-copy form, to cross-reference against historical payroll information should a discrepancy arise in the future.

Review 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 fiduciary committee usually reviews the investment information on a regular basis, and the rest of the report is ignored.

Other information 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, 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.

For a large plan, Form 5500 requires a Schedule H to be attached. The Schedule H requires more information to be reported than a short form filing—Form 5500-SF—which is usually used before a plan becomes a large plan. 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 accounting principles generally accepted 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, 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; nor are there 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 his or her expertise with benefit plan accounting. 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. 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. This can help ensure that you're 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. 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

We frequently work with 401(k) plans undergoing their first required audit and find that many of the plan sponsors aren't 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.

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