Plan Audits

What Is That Auditor Thinking?

Helping the Third-Party Administrators Understand a Plan's Auditor

For the first decade of my professional career, I was an auditor. I began my career at one of the 10 largest CPA firms in the country and then worked for the largest local firm in Southern Arizona. During my time as an auditor, one of my areas of specialty was retirement plan audits. For the last seven years, I have been the COO of a third-party administration (TPA) and actuarial firm. Thus, it has been nice to lend my prior experience as an auditor to my TPA colleagues in an attempt to help answer the question, "What is that auditor thinking?" whenever it arises. The intention of this column is to help service providers, such as TPAs, better understand the auditor and audit process.

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Let's Set the Stage

Your client has had a plan for many years. This year, they have hit the number of participants so that the law requires that the plan be audited by an independent public accountant. (Generally, federal law requires employee benefit plans with 100 or more participants to have a retirement plan audit as part of their obligation to file an annual return. [ERISA § 103(a)(3)]) Your first thought (and likely your client's first thought) may be, "Ugh." However, I advise clients: If your plan requires an audit, do not panic! Being prepared and knowledgeable will help your client throughout the audit process.

Selecting an Auditor

So, where should your client, the plan administrator, begin? The first key to a successful employee benefit plan audit is in the selection of a qualified independent certified public accountant (CPA) auditor. Hiring a plan auditor is a fiduciary function and should be done with great care. The auditor and/or audit firm must not have a financial interest in the plan or plan sponsor, as that could affect his/her independence.

In 2015, the Department of Labor (DOL), Employee Benefits Security Administration (EBSA), and the Office of the Chief Accountant issued a nearly 200-page report assessing the quality of employee benefit plan audits. Perhaps not surprisingly, the report contends that auditors who had the least training and experience (specifically related to these unique audits) were more likely to fail to perform various specific audit tests, which resulted in audits deemed deficient by the DOL. In other words, auditors who specialize in the audit of employee benefit plans typically performed better quality audits that were less likely to be found by the DOL to be deficient.

Thus, when selecting an auditor, the plan sponsor should make sure the auditor performs many plan audits annually. The American Institute of CPAs (AICPA) has an Employee Benefit Plan Audit Quality Center (EBPAQC), which is a national voluntary membership center for CPA firms that audit employee benefit plans. While a CPA firm's membership in the center is not required to be an auditor of employee benefit plans, membership indicates that the firm has agreed to follow several requirements related to specific training, expertise, and monitoring of audit procedures and reports. It often is a good indication the CPA firm has committed time and effort into specializing in this audit area.

The auditor's ultimate goal is to obtain reasonable assurance that the plan financial statements are fairly stated. In addition, the auditor performs procedures to ensure the plan is in compliance with specific requirements of the plan document, and also considers the plan's compliance with the law and regulations.

Section 103(a)(3)(c) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) allows for a limited-scope audit if the plan does not have material hard-to-value or alternative investment assets and if the plan is able to obtain a certification as to *both* the accuracy and completeness of such investment information from a qualified entity. (This applies in most cases where a bank, trust company, or insurance company is acting as a plan trustee or custodian.) The limited-scope audit exemption is implemented by the DOL's Rules and Regulations for Reporting and Disclosure under Labor Regulations Section 2520.103-8. If this limited-scope exemption is not available, the plan will be required to have a full-scope audit, which will then require additional attention by the auditor to testing the investment asset balances. Therefore, an auditor should inquire during the preliminary hiring stages about the investments and if a certification is available so that they can prepare their engagement proposal with an appropriate fee estimate. The questions that the auditor initially asks will affect his/her audit planning and determine the initial audit scope. Needless to say, full-scope audits are more extensive and, therefore, expensive than limited-scope audits, having a significant effect on the fee estimate. Furthermore, if an auditor does not ask the necessary questions to determine the level of the audit's scope in the initial communications, it may be a good indication that the auditor lacks the needed knowledge to perform his task.

A Smooth Audit

A question sometimes posed is how can the plan sponsor and the TPA contribute to a smooth employee benefit plan audit? Here are some good ways that the pain of an audit can be reduced or eliminated:

- *Keep accurate plan records*. The plan records should be complete, up-to-date, and easily accessible. The plan document, adoption agreement, and all related amendments are likely the first things the auditor will request and need. As a prior auditor, I was always astonished that plan sponsors had difficulty in locating the plan document. As we all know, before any action is taken (such as benefit payments, loans, entering new participants), the plan document should be consulted. The auditor will want to know that the plan sponsor is familiar with the plan document.

  Additionally, the auditor will request a sampling of personnel files when they are testing the plan's correct application of compensation and eligibility. Thus, the plan sponsor's personnel files should be complete and accurate. Inaccuracies and inconsistencies between personnel files and census information can lead to participants being inappropriately admitted to the plan, improper allocations of employer contributions, and improper vesting calculations. Additionally, the incorrect application of compensation can lead to errors in contribution calculations. Thus, this will be a major area of testing for the auditors and the plan sponsor should be ready with accurate and complete records.
- *Designate a point of contact at the TPA firm and plan sponsor's office*. Designating one go-to person will allow the audit team to work as efficiently as possible. This designated person not only will coordinate the audit, but also obtain the necessary cooperation of all parties involved, which will reduce the need for multiple requests of various documents and the overall aggravation and time required to complete the audit. Additionally, encourage the plan sponsor to allow the auditor to have direct contact with a point of contact at the TPA firm. Often, the auditor will have questions that can be easily and most efficiently answered by the TPA. By granting the auditor direct access to the TPA contact, the audit will be more efficient.
- *Provide all items on the document request list*. The auditor will provide the plan sponsor with a list of items needed to start and perform the audit. It is often most efficient for the plan sponsor to work with their third-party service providers to decide who will provide which requested documentation. The plan sponsor should review the list and have all items ready upon the auditor's arrival to the plan sponsor's office. The auditor will need additional information as the audit progresses so do not be surprised when the auditor asks for additional information.

  If something is unavailable or irrelevant at the time the audit begins, advising the auditor of that up front will enable him or her to move on, understanding the status. This will prevent multiple requests for a document that is not really needed, or early intervention to get documents from an alternate source if the normal contact is of no help.

- *Internal controls are important*. Internal controls help to safeguard the plan to ensure it is in conformity with applicable regulations and laws. Strong internal controls mitigate the risk of fraud surrounding the plan, as well as limit the number of errors in plan administration. Many institutional trustees and custodians provide plan sponsors with a list of user controls, which are internal controls and procedures that help to safeguard that the plan information provided is complete and accurate, and that the plan's financials are reliable. The user controls at the plan sponsor level are critical to the process and safeguards the trust or custodian are working as intended. Establishing and maintaining strong internal controls is not only important when you are in the middle of a retirement plan audit, but also to protect the plan against fraud and misstatement at all stages of the plan life. (Also, the IRS and DOL both find a presence of internal controls to be a good factor if they examine the plan, leading to easier and possibly less expensive corrections for errors found in their examinations.)

  The auditor will spend the necessary time to understand the controls in place at the offices of both the plan sponsor and the third-party service providers. Oftentimes, the auditor will perform an internal control walkthrough, where the audit team actually observes the controls with the applicable responsible parties to better understand the control process and ensure the controls are operating effectively. Other times, the auditor will use various accepted auditing methods to test the internal controls. Plan administrators must oversee their selected third-party service providers to verify they are performing the agreed-on services. The auditor will also inquire about the internal controls of various third-party service providers, such as the TPA firm.

  Some TPA firms will have a Service Organization Control (SOC) 1 report available for the auditor and plan sponsor. Other TPA firms will not. A TPA firm that is not required to have (and therefore does not have) a SOC 1 report, should not panic. Often, just as is done at the plan sponsor, the auditor will perform a walkthrough of the controls at the applicable service organization (such as the TPA firm) and/or will require the service provider (such as the TPA firm) to provide a detailed memo related to their controls. Additionally, there is a misconception that an auditor can rely entirely on an SOC 1 report. This is not the case. While these reports are helpful in the audit process, the auditor cannot rely entirely on this report.

Testing

Plan sponsors and TPAs have asked me in the past, "What do auditors test and why?" The auditor's ultimate goal is to obtain reasonable assurance that the plan financial statements are materially fairly stated. Thus, the auditor performs procedures to ensure the plan is in compliance with specific requirements of the plan document and government regulations. Below are areas typically audited (in a 401(k) audit) and considerations the auditor likely will evaluate.

Contributions:

- Have contributions (employee and employer) to the plan been made in a timely manner?
- Was the correct compensation definition (as defined in the plan document) applied?
- Have the participants' deferral elections been implemented properly and timely?

Participants and Participant Data:

- Were all eligible employees given the opportunity to participate in accordance with the plan document?
- Were the required disclosures provided timely to the participants?
- Are income and expenses being properly allocated to participants?

Testing in this area will often be done in conjunction with other audit areas.

Payouts:

- Were benefit payments made according to the terms of the plan document?
- What is the process for hardship payouts?
- What is the support paperwork for the benefit payment?
- Is the loan balance properly valued and was the loan issuance and repayment schedule made in accordance to the terms of the plan document?
- Are any loans in default and is that appropriately accounted for?

Investments:

This testing area will vary greatly depending on the determination of whether a limited or full scope audit is required. Investments are typically the largest asset in a plan and the plan administrator is held accountable for ensuring proper valuation and reporting of those investments. Thus the auditor will evaluate how the investments are valued and reported. Each unique investment may have a different valuation method and disclosure considerations and requirements. Therefore, this testing and disclosure of investments will greatly vary based on the audit (limited or full scope) and investment type.

In a limited scope audit, the auditor can rely on the certification of an institutional asset custodian or trustee to reduce the testing on specific investment information (but not completely eliminate all testing). This testing should be far more extensive in a full-scope audit.

Forfeitures:

- How are forfeitures being handled and is the process in compliance with the plan document and Revenue Ruling 84-156?
- Are forfeitures used or allocated during the plan year in which the forfeiture is incurred? Or is the plan incorrectly carrying over plan forfeitures to subsequent plan years?
- Is vesting being correctly applied to participants?

Administrative Expenses:

- Are expenses properly recorded and classified?

Plan Tax Status:

- Were there any issues identified that may affect the plan's tax status?

Prohibited Transactions/Parties-in-Interest:

- Have there been any transactions that are prohibited under ERISA and the Internal Revenue Code?
- Who are the parties-in-interest?

Internal Controls:

- What are the internal controls at the plan sponsor level?
- What are the internal controls at other service provider offices?

If this is the plan's first year under audit, the auditor will perform additional testing to satisfy him- or herself that the beginning balance sheet for the plan year under audit is materially complete and accurate.

Based on testing results, the auditor may need to expand sample sizes, testing areas, and requested documentation. Additionally, each year, the auditor will include elements of unpredictability within their audit procedures.

Reports and Audit Results

Audited financial statements, along with the auditor's report, must be attached to the Form 5500 and filed on or before the normal filing (or extended filing) due date. Beginning the audit process early gives the plan sponsor, plan auditor, and applicable third-party service providers the necessary time to prepare for and perform the audit and will help everyone avoid the stress of a last-minute, or even worse, late filing.

Collaboration

Some third-party service providers, such as TPAs, may find the auditor requests inconvenient (and even annoying), but ideally the TPA and CPA should have a positive, collaborative relationship. Both service providers are looking out for the best interest of the plan. Both service providers have specialized knowledge and can learn from each other. Also both service providers can become excellent referral sources for each other once the level of quality is assessed and confidence in ability is gained.

Once the annual audit is complete, the plan administrator may receive additional written communications from the auditor. These communications typically involve items detected during the audit and should be used to help strengthen the internal controls surrounding the plan and correct any areas of noncompliance. The audit results may bring to light various plan issues that were previously undetected. This provides an opportunity for the third-party service providers to collaborate with the CPA auditor and plan administrator to provide solutions to the issues detected. The auditor may uncover an issue that requires an EPCRS submission to rectify the situation. This could result in additional interesting consulting work for the third-party service providers.

Conclusion

As noted earlier, ultimately, the auditor's goal is to obtain reasonable assurance that the plan financial statements are fairly stated. The auditor will want to work with the plan sponsor and the TPA to achieve this goal. Being prepared, understanding what the auditor is trying to accomplish, and collaborating for a good result all can make the difference in facilitating a smooth audit. ■