When Your Plan Doesn't Need an Audit, but You Want to Act Like It Does….Best Practices for a Self-Audit of Your Retirement Plan

A Practical Guidance® Article by Maria T. Hurd, Belfint Lyons & Shuman

Maria T. Hurd
Belfint Lyons & Shuman

This article addresses self-audit of qualified retirement plans for compliance with the rules of qualified plans under the Internal Revenue Code.

The House with No Rules

Once upon a long time ago, I fell asleep on the couch, as I often do. My astute baby girl speed-dialed my husband to report that she was in a house with no rules, because I had fallen asleep. Also, she said there was no need for him to hurry home, because he should bring pizza with crust, cheese, sauce, and nothing else. She had it under control. She knew the rules and knew how to follow them. Oversight was not necessary.

The Honor System

After the change in the participant counting rules, roughly 20,000 plans no longer need an audit of their financial statements. However, with the increasing prevalence of automatic enrollment, and the new long-term, part-time employee rules, many small plans are scheduled to grow quickly, and become large plans that will need audits. Read more about this in Counting what Counts, Counts the Auditors Out!

New small plans, growing small plans, merging small plans, all the small plans live in the house with no rules. The rules still apply, but there is no independent auditor in charge of verification: the honor system!

Self-Audits or Agreed-Upon Procedures

The honor system comes with an important responsibility. For small plans that have no audit oversight, it behooves plan sponsors to trust, but verify that their plan officials are operating the plan in accordance with its terms. In addition to maintaining sound internal control policies and procedures, plan sponsors can add a layer of verification through a self-audit or an agreed-upon-procedures engagement performed by an independent accountant or specialized professional.

Trust but Verify

Plan sponsors often want guidance on how to implement a self-audit program or what would be the most cost-effective way to get the best value of an audit without the big invoice. Agreed-upon procedure engagements give plan sponsors the opportunity to instruct an independent qualified public accountant to perform specific procedures applicable to the most significant audit areas: contributions and distributions. Two of the most common errors found by the IRS, improper exclusion and use of an incorrect definition of compensation, are directly connected to the proper administration of contributions. Failure to process involuntary cash-outs and required minimum distributions, ineligible hardships, or other in-service distributions are other common findings related to distributions.

Following is a menu of contribution-related procedures that plan sponsors could consider when designing a self-audit program and/or requesting an agreed-upon procedures engagement.

Contribution Testing

Timeliness and Completeness of Contributions: Verify that accurate contributions to the plan are remitted timely to comply with DOL rules and regulations.

- **To Test Completeness**: Obtain a complete list of paycheck dates and a complete list of deferral deposits to the plan by date. The total deferral deposits should agree to the total deferrals reported on the Form W-3. Any discrepancies represent funds withheld from a participant's pay that were not deposited or amounts allocated to a participant that were not withheld from payroll. Discrepancies for each person should be identified and resolved in accordance with the Internal Revenue Service's correction program, the Employee Plan Employee Compliance Resolution System.
- **To Test Timeliness**: Compute the number of days between each paycheck date and the date in which related deferral withholdings were deposited. After establishing a pattern that shows how soon the deferral withholdings can be segregated, identify and report as delinquent contributions any deferral withholdings that were not deposited as soon as they could be segregated from the employer's assets.

Why does it matter? The DOL considers delays in the remittance of deferral deposits as a prohibited short-term loan from the participant to the plan sponsor. Prohibited transactions are subject to reporting and disclosure rules and to an excise tax. See more in our blogs: Delinquent 401(k) and 403(b) Deposits and Calculating Earnings – Do Your Best to do Better!

Demographic Data

Verify the accuracy of employee SSN, date of birth, and date of hire using source documents.

- Obtain and review source documents, such as a Form I-9 or other personnel records to verify that the demographic information on the census used for plan administration is accurate.

Why does it matter? Date of hire affects eligibility to participate in the plan and the vesting computation. Date of birth affects eligibility to participate in the plan, to obtain an in-service distribution, and to obtain a required minimum distribution.

Eligibility: Entry Date

Determine whether all newly participating employees contributing to the plan during the year are eligible to participate based on plan provisions. For plans with automatic enrollment provision, also determine whether contributions began in a timely manner.

- First, identify the population of participants with pre-tax, Roth, or after-tax contributions who have an eligibility or entry date during the plan year under audit.
- Second, determine whether each participant was eligible to contribute on the first contribution date based on the plan provisions. For auto-enrollment plans, compute the number of days between the calculated entry date and the date of the first deferral withholding on the pay-by-pay payroll report to determine whether each participant was auto-enrolled in a timely manner. See more in our blog: SECURE 2.0: Mandatory Automatic Enrollment Coupled with Corrective Contribution Relief

Why does it matter? Failure to follow the plan document is a disqualification error. Excess contributions or improper exclusions must be corrected in accordance with the Internal Revenue Service's correction program, the Employee Plan Compliance Resolution System (EPCRS). Correcting Retirement Plan Eligibility Errors: Improper Exclusion Leads to Corrective Contributions

Eligibility: Opt-out Verification

For a sample of employees that became eligible to participate during the year but did not participate, verify the employee was given the opportunity to participate.

- Opt-out forms are the best practice for eligible employees who are not participating. Alternatively, obtain sign-up sheets for enrollment meetings or evidence that enrollment packages were mailed.

Why it matters: Failure to follow the plan document is a qualification error. Improper exclusion of an eligible employee must be corrected, most often with an employer-funded Qualified Nonelective Contribution (QNEC) for the missed deferral opportunity plus the missed employer match. See our blog The New EPCRS for the mechanics of Improper Exclusion corrections.

Eligible Compensation for Deferrals

Participant 401(k) or 403(b) Deferral Elections Were Followed: Verify that payroll deferrals are calculated based on the plan's definition of compensation. On a sample basis, determine whether employee deferrals are properly withheld and remitted to the plan in accordance with the employee's election.

- Request a pay-by-pay report by participant, including gross earnings and every type of pay that comprises gross earnings, as well as 401(k) withholdings for each pay period.
- Verify the completeness of the pay-by-pay report by comparing control totals to payroll tax filings, or the Form W-3.
- Review the plan document to obtain the definition of eligible compensation for the plan being audited.
- Obtain a schedule of participant deferral elections in place for the whole year and deferral election changes.
- Apply the participant's deferral election to eligible compensation for that participant based on the relevant plan provisions and the deferral election date. Compare the computation to the amount withheld and allocated to the participant's account.
- Obtain deferral elections for a sample of participants and recompute the deferrals that should have been withheld from eligible pay during the audit year. Compare the recomputed amount to the amount withheld from the participant's pay.

Why It Matters: Use of the incorrect definition of compensation is the most common finding in both IRS audits and Independent Qualified Public Accountants' (IQPA) financial statement audits.

- If the test uncovers an error, the plan sponsor must identify all the participants affected by the error and complete a correction that is compliant with the Internal Revenue Service's correction program, the Employee Plan Compliance Resolution System (EPCRS). See our blog SECURE 2.0: Mandatory Automatic Enrollment Coupled with Corrective Contribution Relief for Automatic Enrollment Failures

See more in our blog series **Tips and Traps of Compensation:** Part I **–** Part II **–** Part III **–** Part IV **–** Part V for the mechanics of deferral contribution error corrections.

Employer Match and True-up Contributions

On a sample basis, determine whether employer match contributions and true-up contributions, if applicable, are properly calculated and remitted to the plan in accordance with plan provisions.

- Using YTD eligible compensation from the pay-by-pay report for selected participants and the match formula stipulated in the plan provisions, calculate expected employer match and compare the computation to actual employer contribution amounts remitted to the plan.
- Determine whether the plan provisions include a true-up provision and verify that the match true-up was deposited for a sample of participants who did not contribute deferrals evenly throughout the year.

Why It Matters: Failure to follow the plan document is a qualification error. If the test uncovers an error, the plan sponsor must identify all the participants affected by the error and complete a correction that is compliant with the Internal Revenue Service's correction program, the Employee Plan Compliance Resolution System (EPCRS). See our blog SECURE Act 2.0 Brings New and Improved Self-Correction Opportunities

Profit Sharing and Nonelective Employer Contributions

On a sample basis, determine whether profit sharing and nonelective employer contributions are calculated in accordance with plan provisions, and using accurate eligible compensation.

- Allocation of Assets and Contributions to Participant Accounts Obtain a schedule of participant account balances.
- Reconcile the beginning and ending balances to the Schedule of Net Assets on the Form 5500.
- Reconcile the 401(k) or 403(b) contribution amount to the Form W-3 or the master payroll report.
- Reconcile the match contributions to the payroll report or match computation tested above.
- Once the completeness of contributions allocated to participants in total has been established, on a sample

basis, trace the deferral allocation to a participant's account to the respective Forms W-2.

- After adjusting for timing differences related to receivables and other accruals, identify and resolve any discrepancies between the participant account balance report and the plan's financial statements, including beginning assets, contributions, distributions, and ending assets.

Distribution Procedures

Perform the following procedures related to benefit payments:

Completeness of Distributions

- Obtain a Form 1099-R report listing all distributions and withdrawals by participant.
- Reconcile its totals to the trial balance, financial statements, and/or Form 5500, as applicable.

Accuracy of Distribution Processing

- For selected participants on the schedule previously obtained, test the benefit payment as follows:
  - Determine that income taxes have been withheld if the distribution was not rolled over.
  - Trace the distribution amount to the individual participant's account.
  - Verify that payroll stopped for participants who took a terminating distribution.
  - If in-service distributions are allowed at a specified age, such as 59 1/2, verify the relevant participants' ages.
  - Verify that the benefit payment was determined in accordance with the plan's provisions. For example, based on the participant data tested (such as evidence of age, years or hours of service, earnings, vested percentage and related forfeiture amount, or other relevant bases), test or recompute the benefit amount and check the recipients' eligibility to receive the benefits.
  - Determine that payments to participants or their beneficiaries do not exceed the balance in their participant's account, net of any participant loans. In addition, if the participant is withdrawing from the plan, verify that the participant's account is zero at the end of the year, and that a termination date is entered on the census.

See more in our blog SECURE 2.0 Turned Overpayment Errors into Lucky Mistakes.

Hardship Withdrawals

- For hardship withdrawals:
  - Review the financial need indicated in the withdrawal request and any related supporting documents, as applicable, and consider whether it meets the plan provisions and tax requirements for a hardship withdrawal.
  - Determine that the amount withdrawn does not exceed the amount available in the contribution sources as defined by the plan.
  - Determine, based on the plan document and Reg. 1.401(k)-1(d)(3)(iii), that all requirements were met to take the hardship withdrawal.

See more in our blog Changes to Hardship Withdrawal Administration from the SECURE 2.0 Act

Rollover Distributions

- If the payment is a rollover distribution, that is, a transfer to another qualified plan or to an individual retirement account, verify that the plan allows rollover distributions, that the rollover was made according to the provisions of the plan and that no tax was withheld.

Mandatory Cashouts

- Determine that mandatory cash-out provisions have been observed.

Corrective Distributions

- Verify that corrective distributions were processed pursuant to the discrimination testing results, as applicable.

Required Minimum Distributions

- Verify that Required Minimum Distribution rules are being processed in accordance with plan provisions and SECURE 2.0 rules.

See more in our blogs SECURE 2.0 Removes the RMD requirement for Roth 401(k) Accounts, SECURE 2.0: Required Minimum Distributions – Do They Start at 72 or 73 for 2023? and Required Minimum Distribution Errors: Did you take too much, too little, or Just Enough?

Forfeitures

- For each participant forfeiture recalculated for the distributions tested, trace the participant's forfeited amount to the record of total forfeitures for the period. Trace the total to documents supporting either the reallocation to remaining participants or to offset administrative expenses or employer contributions in accordance with plan provisions. Ensure that forfeitures are being used timely, as noted in the plan provisions.

Participant Loan Procedures

Perform the following procedures for participant loans:

Completeness of Loan Balances

- Obtain or prepare a schedule of participant loans, including the beginning balances, transactions during the year, ending balances, and income earned during the year.
  - Trace or reconcile beginning loan balances to the prior year Form 5500 ending balance and the current year Form 5500 beginning balance
  - Trace or reconcile beginning and ending loan balances, transactions during the year, and income earned during the year to the working trial balance or the custodian statement, as applicable, and the Form 5500.
  - Determine that any amounts reported by the custodian agree with the payroll records.

Compliance with Plan Loan Provisions and IRS Rules

- Consider whether participant loans comply with ERISA, tax, and plan requirements by assessing whether the following requirements are met:
  - The plan document must authorize loans to participants on a reasonably equivalent basis that does not discriminate in favor of highly compensated employees.
  - The loans must bear a reasonable rate of interest.
  - The loans must be adequately secured.
  - The term of the loans must comply with the plan's loan policy and must not exceed five years (unless for the purchase of a principal residence).
  - Spousal consent was obtained, if required by the plan document.
  - The loans are properly segregated from other investments within individual participant accounts.
- Examine the agreement supporting the loan and compare descriptions and terms to the information on the schedule of participant loans.

Notice Distributions

Verify that notices were distributed:

- As applicable, ensure that all required notices, including but not limited to the Safe Harbor, Qualified Default Investment Alternative (QDIA), and Plan Expense notices were timely provided to participants.

IRS Audits and DOL Investigations

Under the honor system created through the audit waiver for small plans, the IRS and the DOL choose to trust, but also when to verify. Failure to follow the plan provisions is a qualification error, and nobody wants to get disqualified. Plan officials should always play by the rules, even in the house with no rules, by having processes and procedures designed to operate the plan in accordance with its terms. However, in the absence of an audit requirement, it behooves every small plan sponsor to trust, but verify, to stay qualified.

For additional content by Maria Hurd, see Maria's blog, The Art of the Qualified Plan Audit.

Related Content

Resource Kits

- ERISA Retirement Plan Notices Resource Kit
- Plan Loan Resource Kit
- Retirement Plan Policies and Procedures Resource Kit

Maria T. Hurd, Director, Belfint Lyons & Shuman

Maria leads a team of specialized retirement plan auditors and the retirement plan audit niche at BLS, the largest locally owned CPA firm in Delaware. She is responsible for planning, supervising, and reviewing audits of single, multiemployer, and government 401(k), 403(b), and Taft-Hartley plans. Maria is known as one of the go-to auditors in the industry, which has helped her niche experience exponential growth in the number of plan audits due to the confidence of her referral sources. As a result of her team's efficient auditing and value-added services, she has a 95% client satisfaction and retention rating.

Maria frequently attends and speaks at educational conferences, including the AICPA/DOL National Employee Benefit Plan conference and the American Society of Pension Professionals and Actuaries conferences. Maria gives the auditor's perspective in educational panels targeting plan sponsors, investment advisors, third-party administrators, and other service providers in the industry.

Maria spearheads the firm's employee benefit audit blog – *The Art of the Qualified Plan Audit*. Her blogs are frequently re-published in several national publications and she has authored white paper publications for major asset management companies.