# Common Operational Errors in Large-Plan Audits

BY CARIANN J. TODD

*Errors. They are everywhere if you look closely enough. But there are common themes in most plan errors that auditors of large plans come across every year. This article addresses the most common errors, why they occur, and how they can be avoided.*



We have just finished another exciting season of auditing employee benefit plans at our firm. Like all the seasons before, we encountered a long list of issues with plans, some we had seen before and some we had not. As I look back at the issues, I can't help but ask myself: Do plan sponsors read their plan documents? Do employers really care about plan administration for their 401(k) plans or do they just feel like they have to offer a plan to be competitive in the hiring market? Do participants ever look at their paystubs or their 401(k) statements? We don't make the rules, why do the auditors have to be viewed as the bad guys? And the question that has nagged me for years… If we are finding these errors in the large-plan environments, what goes undetected in small plans? I try not to dwell on that one.

What I have learned over the years is that all plans have errors. The regulations are so complex, and the accounting and recordkeeping so tedious, that nobody gets it perfect. Some errors are minor, some are egregious, and many go undetected for years, even in a large-plan environment, because auditors use sampling as their method for testing plan attributes. Sampling is necessary, but it is also not foolproof. Sample sizes vary based on plan size and other factors like fraud risks and internal controls. Sample selection methods range from targeted to systematic, random, or haphazard. All of these factors mean that sampling has inherent limitations. However, I do not know of any plan sponsor that would be willing to pay for the cost of an audit if we tested 100 percent of the population, so sampling it is.

From years of experience sampling and testing plan attributes in different ways, there are common errors that we seem to come across every year. I would like to share those with you and give you our perspective on them, why they happen, and how they can be avoided.

## Compensation Errors

This easily tops the charts as the #1 error we find when we audit plans. When we are testing participant data, like wages and contributions, our first step is to look at the plan document and adoption agreement and determine the plan's definition of compensation. From there, we will test whether the census provides Code Section 415 compensation or some other similar version of gross compensation, and whether that amount agrees back to a participant's annual payroll summary. From there, we move on to testing elective deferrals, a process where we look at a participant's deferral election, apply it to the plan-eligible compensation they received, and compute an expected contribution. Then, we test whether the contribution remitted to the plan agrees with the expected contribution. It is during this process that we look more closely at plan compensation exclusions, if there are any. The most common exclusion is bonuses, but many plans have a variety of exclusions, such as overtime and fringe benefits. In a large percentage of the plans we audit, plan compensation is W-2, no exclusions other than severance. Unfortunately, in a lot of those plans, there are exclusions nonetheless being applied; again, the most common is bonuses.

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I am not sure what it is about bonuses, but they cause us the most grief. In plans where they *are* excluded from eligible plan compensation in the adoption agreement, employers are deferring on them anyway. In plans where they are *not* excluded from plan compensation in the adoption agreement, employers are excluding them for computing elective deferrals. And sometimes, it is a mixed bag.

Another common compensation error centers on fringe benefits. The two biggest offenders are group term life and vehicle allowances. I know that, technically, if plan compensation is W-2 compensation, then the Form W-2 rules, but the common sense side of me says: "What average Jane in America expects to have 401(k) withholdings applied to their excess group term life W-2 add-back or their vehicle allowance?" Logically that just does not make sense! But, alas, we see fringe benefits being treated incorrectly all the time.

Finally, the last compensation error we see frequently relates to manual or off-cycle payroll checks. These seem to be very common, regardless of the size of the employer. Most of these checks have the payroll deductions computed manually, which, from an internal control perspective, can be asking for trouble unless there are proper review procedures in place. And because they are off-cycle or perhaps the employee's final paycheck, the deduction for 401(k) deferral commonly is overlooked.

Why do compensation errors happen? Lack of communication? Maybe no one read the final version of the adoption agreement? Or maybe the payroll department is using the 401(k) marketing materials instead of the adoption agreement? More commonly, there is a lack of understanding of the plan's compensation definition and its finer distinctions, how to apply the deferral rules in the payroll system, and the importance of enforcing the proper definition of compensation without deviation. But we often have seen in the past couple of years that, when the plan was amended and restated, the adoption agreement compensation definition was inadvertently changed and no one noticed, or that the person completing the adoption agreement checklist independently made the change but did not understand the implications of the new selection. We know this because, when we find compensation errors, the answers we get from payroll are, "We have never included bonuses or vehicle allowance for 401(k)!" or "We don't really have a policy; it's just whatever people want when the bonus payroll comes around."

So how do we keep compensation errors from happening? If you are a third-party administrator, please sit down with your client and discuss the detailed provisions of the plan, specifically the definition of plan compensation, and request that a member of the payroll department be present. Involving payroll in these discussions is crucial to proper implementation in the employer's payroll system. If your client has a lot of different types of compensation (for example, 75 different wage codes), offer to help them (for a fee, of course), to ensure that all of the pay codes are set up correctly under their plan compensation definition. If you are a plan sponsor, take the time to read over your adoption agreement and plan document. Yes, the summary plan description is an easier read, but it may not give you all of the details you need regarding plan compensation. Then, have a meeting with your payroll department to ensure that the payroll system is set up to apply the definition of compensation correctly for elective deferrals. Finally, in all cases, the individuals doing payroll need to understand that any variation from the plan document is an error. And errors cost the employer money. If a change is to occur, an amendment is likely needed.

## Hardship Withdrawals

The errors we see in this area range from zero documentation to approval for a reason not included in the safe harbor definition. Our most legendary discovery was that a person was given an $18,000 hardship withdrawal and, on the application form, under "Reason for the Withdrawal," the participant wrote: To buy a Harley-Davidson. Kudos to the guy for being honest; jeers to the human resources person who approved the withdrawal.

More common than wacky hardship justification is a lack of sufficient documentation, or a complete lack of documentation at all. Fortunately, the IRS did everyone a favor in February 2017 when it issued its Memorandum for Employee Plans Examinations Employees on the subject of Substantiation Guidelines for Safe-Harbor Hardship Distributions from Section 401(k) Plans (and a similar memo for 403(b) plans). Now we no longer have to wonder what sort of documentation should be reviewed and maintained by the plan sponsor for approval of safe harbor hardship distributions. If you have not seen the new guidance yet, here is the link: *https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf*. (Note that there are steps the employer must take to advise the employee of his or her obligations in order to use these guidelines. And, you can be sure, we auditors will be looking for proof that these notices have been provided.)

Why does this happen? Usually, for one of two reasons: (1) the approval of hardship withdrawals has been outsourced; or (2) the individual responsible for approval of hardship withdrawals does not want to get involved in the personal business of the employees. With respect to (1), I have been to a lot of ASPPA and AICPA conferences and it has been said from the pulpit more than once that plan sponsors need to be extremely careful and cautious if they choose to outsource hardship withdrawal approval because the fiduciary responsibility for proper documentation still lies with the plan sponsor. In addition, it has been said that in no way, shape, or form can a participant "self-certify" by clicking a button that they meet the hardship requirements. We have encountered more than one scenario where the approval of hardship distributions was outsourced to a recordkeeper and the supporting documents provided to us by the recordkeeper did not meet the safe harbor definition of a hardship.

With respect to (2), I understand that it is a very slippery slope trying to balance fiduciary responsibility with privacy laws and HIPAA regulations. We had one client say a few years ago "It's not my business; if they say they have a hardship I'm going to believe them." This is a bit extreme and similar to sticking your head in the sand. Again, now that the IRS has issued the Memorandum, we all have very specific guidance to follow that allows us to walk along that slippery slope and still keep all of the interested parties happy.

How do we keep hardship errors from happening? We all need to help get the word out to plan sponsors about the Memorandum. I was lucky enough to be able to attend a national conference where the Memorandum was discussed. But had I not attended the conference, would I know about it? Not sure. We plan to add a blog about it on our firm's website, then email blast our clients about it. If you are a third-party administrator or recordkeeper, I would encourage you to do the same. If you write articles for other publications, or you have influence over one of the many employee benefits websites, please use those avenues to spread the word.

### Timely Remittance of Elective Deferrals and Participant Loan Repayments

I have to be honest with you; auditors really dislike this part of the audit. Due to the vagueness of what is timely in the first place for a large plan, it is really hard to draw the line as to what we think is late and then convince our clients as to why. We rarely get any help or support in this area from third-party administrators or recordkeepers. Ninety-nine percent of the time, their stance is that "timely" means "whatever the auditor says." From our perspective, the plan sponsor should be making the call, with assistance from the service providers that they are paying for expertise in plan administration. Alas, it does not usually work that way, so we are stuck being the bad guys.

Sans any more specific guidance coming down the pike, we have to use judgement when we draw the line. Do we always draw the line in the right spot? Probably not. The hardest cases are when the number of business days it took an employer to remit the deferrals to the plan over the course of a plan year ranges from three to seven days, with most of the remittances being in the three- to five-day range. It is obvious that this company has demonstrated an ability to remit within three business days. The DOL has opined in various conferences that this is the standard that it uses, and we have seen that in investigations. If we come down hard and try to enforce this rule, find that four days is late, the client will slam the phone down in disgust because we are unreasonable, then start working on an RFP for a new auditor. If we say six days is late, they ask why did we pick six? That six is less than a week? I closed my eyes and picked one? There is no good answer here and I cringe every time we have to even talk about it. If there was a time to bury your head in the sand, this is the time I would pick.

How do late contributions happen? In the spirit of shock and awe, let me tell you about a situation we encountered this year with a plan that changed service providers. The new recordkeeper's platform and the plan sponsor's payroll provider were having technical difficulties communicating with each other. A manual process had to be created as a patch until the software challenges could be resolved and the recordkeeper only allowed the plan sponsor to use the manual transfer process to remit elective deferrals once a month for over six months. The plan's representative at the recordkeeper told the plan sponsor, "It's no big deal, you have 45 days to get the money into the plan anyway." WHAT??? We were shocked by this statement made by a representative of a very well-known recordkeeper to a large plan (over 1,500 participants). We were lucky to have a plan sponsor that understood the rules and agreed with us that the majority of the deposits during that six-month time period were late.

She was already unhappy with the recordkeeper in the first place over the software problem but felt helpless to do anything different.

What can be done to avoid late contributions? Educate, educate, educate. In the three to seven days remittance example, we have become very diligent in impressing on our clients the importance of consistency. When a plan sponsor consistently deposits contributions into the plan, it takes judgment off the table, both for their plan auditor and ultimately a DOL investigator they might encounter in the future. In the case of the change in service providers discussed above, the plan sponsor did not realize that it had alternatives to segregate the plan assets from the plan sponsor's assets and meet the timeliness requirement, despite not being able to have the money invested with the recordkeeper on a pay period basis. In my opinion, the recordkeeper should have advised the plan sponsor on the alternatives, because the limitation was imposed on the plan by the service provider.

## Conclusion

As I said in the beginning, every plan has errors. Most plan sponsors are very receptive to our advice for avoiding errors in the future; however, they are understandably frustrated that they had errors in the first place (especially the ones that cost them money). While readers of the *JPB* would all agree that the plan sponsor bears the lion's share of the responsibility for those errors, I think many times their perspective is that the service providers are falling short on the service side. They feel like the service they are receiving is too impersonal, more of a product than a service. They are looking for that extra touch, a personal relationship with a service provider that provides them with guidance and advice so that they understand everything they need to know to keep their plan qualified and avoid errors in the first place.

But, as we all know, that personal touch costs money and the market is extremely fee-sensitive. Look for ways that you can add that extra touch, without a lot of additional investment of time, which provides benefits beyond the touch itself. An example is a newsletter you send regularly to your clients that addresses common plan administration challenges in each issue. Other examples include a blog on your website or an annual letter to your clients with reminders about plan errors and how to avoid them. Anything you can do to demonstrate your expertise while at the same time educating your client base is beneficial to both parties.

In closing, being a plan auditor can be very challenging when errors are discovered and balancing doing the right thing while maintaining a good relationship with our clients. Especially when the response we get is, "Can we just fix it going forward?" Eeek. We try hard to push the discussion back to the plan sponsor and its service providers and, in some cases, ERISA counsel. It is not really an auditor's role to say what should and should not be done under EPCRS; our role is to throw the flag, not tell you whether to accept or decline the penalty. ■