PAVILION

OPERATIONAL COMPLIANCE REVIEWS

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Do you know with certainty whether your plan is operating in full compliance with the plan document? Are you confident that it is operating in accordance with the rules of the Internal Revenue Service (IRS), the Department of Labor (DOL) and the Employee Retirement Income Security Act of 1974 (ERISA)? If you answered "no" to either question, you and your plan could be at risk.

A retirement plan sponsor has a fiduciary duty to ensure that the plan complies with all federal and state rules and regulations. Plan sponsors must follow the plan's provisions without deviating from them unless the plan has been accordingly amended. Failure to follow the provisions can lead to plan disqualification. For the 2015 fiscal year, the Employee Benefits Security Administration (EBSA) reported that 67.2% of employee benefit plans investigated resulted in financial penalties or other corrective actions.

Financial Audits versus Operational Compliance Reviews

Your independent auditor conducts an annual audit to provide an opinion as to whether the financial statements and schedules required to be included in the annual report (i.e., Form 5500 and Schedules) are presented in accordance with generally accepted accounting principles. This examination must be conducted in accordance with "generally accepted auditing standards" (GAAS). A GAAS audit is not designed to ensure compliance with all of ERISA's provisions or other requirements applicable under the Internal Revenue Code. Auditors are engaged by plan administrators only to review the plan as it relates to the presentation of financial data.

Operational compliance reviews, on the other hand, are concerned with validating the process being reviewed, with no restriction on whether it impacts the financials. An operational compliance reviewer wants to know that the process works, whether it is replicable, and consistent with the plan document.

Impact of Operational Errors

Errors can result in financial penalties. The longer the errors persist, the more it will cost to make them right. For fiscal year 2015, EBSA received $14.3 million under the Voluntary Fiduciary Correction Program, a program that helps plan sponsors identify and fully correct certain errors for ERISA plans.

Errors can result in employee confidence issues. Correcting issues and having to communicate them to employees one time may not be a big deal. However, correcting multiple issues and telling employees about them repeatedly, can erode employee confidence and may hinder plan participation. Furthermore, disgruntled employees may complain to the DOL which, in turn, may trigger an investigation.

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Errors, if not properly addressed, can ultimately lead to plan disqualification which poses serious tax ramifications to employers and employees. Employees must pay taxes on employer contributions that have been made, and they are not permitted to roll over money from a disqualified plan to another retirement plan or IRA. The employer's tax deduction is impacted as well, and the trust must pay income taxes on trust earnings. Plan disqualification should be avoided at all costs.

Where to Begin

Deciding how and where to begin in conducting an operational compliance review can be daunting. Engaging an independent, third-party consultant experienced in operational compliance reviews may be a good place to start. Whether or not you engage a third party to conduct a review, you will need to define the scope. Although ideal, reviewing all areas of plan administration perhaps is not feasible.

To help define the scope of the review, consider the following questions:

- Do you have a prototype, volume submitter, or individually designed plan document?
- Have there been any recent changes to the plan document?
- Have there been any changes to any of the service providers, including payroll and record keepers, over the past few years?
- Have you had to perform any corrections recently, perhaps without fully understanding how the errors occurred?
- Have there been any data changes or file changes as they are provided to the record keeper?
- Is there money in the budget to cover the review?

The IRS has provided a list of the **top 10 mistakes** it encounters when reviewing defined contribution plans:

1. Failure to update the plan document;
2. Failure to follow plan provisions;
3. Using an incorrect definition of compensation;
4. Incorrect allocation of employer match;
5. Failure to correct the ADP/ACP nondiscrimination testing;
6. Failure to include all eligible employees;
7. Failure to limit elective deferrals to the annual deferral limit;
8. Late deposit elective deferrals;
9. Failure to administer participant loans properly; and
10. Incorrect administration of hardship distributions.

Some of these errors, such as failure to update the plan document, failure to follow plan provisions, or using an incorrect definition of compensation, can apply to defined benefit plans as well. In our experience, we have encountered several issues related to definition of compensation, loan administration, unallocated revenue sharing and forfeiture accounts, along with treatment of uncashed checks and lost participants. The IRS has provided correction methods to address many of these mistakes.

The Process

A thorough operational compliance review should involve the following key steps:

- Review of the plan document and amendments, along with summary plan descriptions and a summary of material modifications;
- Review of required notices sent to participants, such as quarterly statements, initial and annual 404(a)(5) participant fee disclosures, Qualified Default Investment Alternative (QDIA) notices, safe harbor notices, etc.;
- Review of service provider contracts, such as record keepers and trustees/custodians;
- Discussions with the people who administer the plan, which may include the record keeper, trustee/custodian, payroll and benefits administration personnel;
- Review of plan administrative manuals, record keeper operational manuals, procedural documents and policy statements; and
- Review of sample participant transactions and data for each of the areas being reviewed.

Reviewing and comparing a record keeper's administrative or operational manual with the plan document is an essential step in the review process. There tends to be a higher propensity for errors to occur when a record keeper is administering a plan that has an individually designed document versus its own prototype document. And in many cases, no such administrative or operational manuals even exist.

Lack of documented procedures can be cause for concern in ensuring the consistency and integrity of administering the plan, especially when there are any changes to the record keeping infrastructure, such as changes to plan provisions, modifications or upgrades to the record keeping system, or even personnel turnover.

What You Should Expect From an Operational Compliance Review

Going through this process may lead to discovery of errors you don't necessarily want to find, but there are things you do want to gain, such as perspective and overall confidence on your plan's operations. Aside from finding errors, here are some things you should capture from an operational compliance review:

- Areas of improvement for operational efficiency, including opportunities to maximize your record keeper's outsourcing capabilities;
- Answers to your questions on whether your plan's provisions and administration would be considered "typical", and how they compare to industry best practices;
- An overall rating or report card of how your record keeper or service provider compares to industry peers; and

- Confidence that if your plan is approached by the DOL or IRS, you are ready for an investigation that will conclude with a letter saying “no further action is contemplated at this time”.

Summary

Embarking on an operational review may seem intimidating but, with a well-thought-out plan, process, and the right resources, a successful review will uncover potential issues so you can resolve them before the IRS or DOL arrive at your door. The rewards for your efforts may include perspective on industry best practices and how you can operate the plan more efficiently.

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