

PERSPECTIVES ON EMPLOYEE BENEFITS

Summer 2006

Plan Audits – What's Required?

Most employer-sponsored retirement plans must include audited financial statements and an independent accountant's opinion regarding the statements in their annual Form 5500 filing. Here's a closer look at what's involved.

Why an Audit?

In addition to fulfilling federal reporting requirements -- and helping you avoid penalties for filing an inadequate, incomplete, or late report -- securing a professional audit can help protect your plan's financial integrity and ensure that it will have the funds to pay participant benefits. An audit can reveal any problems your plan may have, and your auditor may suggest ways to improve your plan's controls and operations. However, an audit is not designed to ensure compliance with the pension law's provisions.

Which Plans Need One?

Plans with 100 or more participants at the beginning of the plan year -- so-called "large plans" -- are generally subject to the annual audit requirement. In general, the audit requirement also applies to a plan with fewer than 100 participants -- a "small plan" -- unless the plan satisfies three waiver conditions:

- At least 95% of the plan assets must be "qualifying plan assets." These are assets held by certain regulated financial institutions, mutual fund shares, investment and annuity contracts issued by an insurance company, qualifying employer securities, and certain other assets that the regulations define. Or, if the qualifying plan assets are less than 95% of the total, any individual holding nonqualifying assets must be bonded for at least the value of the nonqualifying assets.
- The plan's Summary Annual Report (SAR) must disclose more information to the plan's participants and beneficiaries than is ordinarily required, such as the identities of the financial institutions holding qualifying plan assets and of the bonding company.
- Upon the request of a participant or beneficiary, the plan administrator must provide no-charge copies of statements received from the financial institutions holding or issuing qualifying plan assets and evidence of any required fidelity bonds.

A plan may be able to file Form 5500 as a small plan and qualify for the audit waiver if the number of participants covered is between 80 and 120 at the start of the plan

year and the plan filed Form 5500 as a small plan for the prior year.

Limiting the Audit's Scope

Federal law lets a plan sponsor/administrator limit the scope of the plan's annual audit if banks or insurance companies hold the plan's assets and provide written certifications. We can advise whether limiting the scope of your plan's audit would be appropriate in your situation.

Employers shouldn't overlook the importance of securing a quality plan audit if one is required. Please call our firm if you would like to discuss your plan's auditing needs.

Questions a Plan Audit Can Answer

- Are the plan assets fairly valued?
- Are the plan obligations properly stated and described?
- Were contributions to the plan timely received?
- Were all participant accounts fairly stated?
- Are there identified issues that may affect the plan's tax status?
- Were benefit payments made in accordance with plan terms?

". . . protect your plan's financial integrity"

Handle With Care

Do you employ people part-time? If so, you may want to review your retirement plan provisions concerning part-time employees. A recent IRS bulletin* warned that plan provisions dealing with exclusions of part-time, seasonal, or temporary employees may violate the tax law if they impose an invalid, indirect service requirement.

Under the tax law, the maximum service requirement a retirement plan can impose for participation is generally one year -- defined as 1,000 hours of work in a 12-month period. The IRS considers plan documents defective if their wording could require more than a year of service.

For example, excluding employees with "customary employment" of "not more than 20 hours per week" is an invalid service requirement, because these employees could work 1,000 hours in an eligibility computation period. A defective plan provision alone can cause a plan to lose its tax-qualified status, regardless of whether any of the employees defined in the provision actually work 1,000 hours in a year.

The bulletin instructs IRS document specialists to challenge plans with potentially improper employee exclusions. A plan may not rely on a current determination letter issued after June 30, 2001, with respect to whether the plan's exclusion classifications, if any, violate the service requirement. Employers can remedy

problems by using the Voluntary Correction Program.

Three Examples from the Bulletin

Part-time and Seasonal Employees. Two plans exclude employees classified as part-time or seasonal. Plan A has no problem because its plan provision excludes employees who work less than 1,000 hours in an eligibility computation period.

Plan B defines a part-time or seasonal employee as an employee who is scheduled to work less than 1,000 hours a year. So, an employee who actually works 1,000 hours or more could be excluded. The indirect service requirement could create a violation. A remedy would be to amend the plan to include any employee who completes at least 1,000 hours of service in an eligibility computation period, notwithstanding any exclusion classifications.

Hourly Employees. Plan C imposes a one year of service requirement and also excludes hourly paid employees (defined as those who receive an hourly wage for their services). This is not a problem, because the exclusion is based on job classification. However, if hourly paid employees are defined as employees who receive an hourly wage and whose customary employment is not more than 20 hours per week, the plan could improperly exclude an employee who worked at least 1,000 hours in an eligibility computation period. Amend-

ing the plan to eliminate the time-based definition of hourly would solve the problem.

Undefined Class. Plan D provides for one year of service as a condition of plan participation. It also excludes Class B employees, but does not define them. The bulletin requires examiners to determine whether the classification is based on an age or service requirement that could violate the tax law. A possible remedy given in the bulletin: Define Class B as members of the employer's substitute work force, as distinguished from its full-time and part-time workers, thus basing the exclusion on availability to work instead of hours of service.

* Employee Plans Determinations Quality Assurance Bulletin: Part-Time Employees Revisited, FY-2006 No. 3 (Feb. 14, 2006)

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Can We Help?

Our firm offers a broad range of employee benefit services. If we can be of service to you, please call Debra Kilham at 603-653-0044.

Benefit Notes

Sample Roth 401(k) Plan Amendment

The IRS recently released a sample plan amendment for use by employers that offers employees the option of making Roth contributions to their 401(k) plan accounts. The sample amendment may be used as is or adapted to meet specific plan needs. Employers that allow employees to make Roth contributions must amend their plans to this effect by the end of the plan year in which Roth contributions are first allowed.

SIMPLE IRAs

After finding that a significant number of employers with SIMPLE IRA plans had not timely updated their plan documents for

changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the IRS has extended the deadline for such changes to December 31, 2006. Failure to update a plan for EGTRRA can cause the employer and employees to lose tax benefits.

Critical 401(k) Plan Issues

The Institute of Management & Administration asked 401(k) plan sponsors what they saw as the most critical plan issues they expect to face in 2006. Here are their top three responses: (1) improve plan performance and participation rates (75.6%); (2) improve fiduciary oversight and reduce risk (51.7%); and, (3) expand or add Web-based in-

vestment education, enrollment, and loans (45.6%).

Lifecycle Funds

Lifecycle funds can offer employees a simple one-fund way to invest for retirement. However, it seems many plan participants -- even those who are invested in a lifecycle fund -- don't understand how they work. A recent study of the federal employees' Thrift Savings Plan found that 55% of the employees investing in a lifecycle fund had also put money into at least one other fund offered by the plan. Sixteen percent of those invested in a lifecycle fund also had investments in all five of the stand-alone funds offered by the plan.

New Pension Reporting Rules Proposed

In an effort to increase the transparency and completeness of financial statements for shareholders, creditors, employees, retirees, and other people who use them, the Financial Accounting Standards Board (FASB) recently proposed rules that would require employers to report their defined benefit pension plans' overfunded or underfunded status on their balance sheets.

Current FASB standards require that information about a defined benefit pension plan's overfunded or underfunded status be reported in the notes to financial statements. Under existing stan-

dards, the recognition of certain changes in plan assets and obligations that affect the cost of providing benefits can be delayed. This incomplete method of reporting can make it more difficult for financial statement users to assess the sponsoring employer's financial ability to pay promised pension benefits.

Reporting Changes

Under the FASB proposal, a plan's overfunded or underfunded status generally would be measured as the difference between the fair market value of the plan assets and the plan's benefit obligation. Employers would have to measure plan

assets and obligations as of the date of their financial statements.

Effective Date

The proposed changes would apply to public and private companies and nongovernmental nonprofit organizations. They generally would be effective for fiscal years ending after December 15, 2006. However, private companies and nonprofit organizations wouldn't be subject to the proposed rule requiring pension plan assets or obligations to be measured as of the balance sheet date until fiscal years beginning after December 15, 2007.

What Workers Say

For many employees, the money in their employer-sponsored retirement plan represents the major part of their retirement savings. Adding features to your plan that encourage participation and provide retirement planning education can strengthen this valuable employee benefit. What features might you consider? The 2006 Retirement Confidence Survey* gives some insight into choices employees favor.

Automatic Features

A majority of employees surveyed liked the idea of automatic plan enrollment and contribution increases.

- 69% favored automatic enrollment.
- 65% were in favor of having their employer automatically increase their contributions whenever they receive a pay raise.

In addition, 59% said they would like their contributions to be automatically invested for them, unless they opted to choose investments on their own. How would employees like their contributions to be invested? Almost three quarters of those surveyed (73%) are interested in investing in lifecycle funds that become more conservative as retirement nears. The next most popular investment choice was balanced funds (73%), followed by professionally managed accounts (70%) and money market funds (61%).

Not all employees think automatic investment is the way to go. Nearly half (47%) view investing their accounts themselves as the best way to achieve their retirement savings objectives.

Education and Advice

Employees appear to make some use of the education materials and advice their employers offer. Three out of ten employees (29%) receiving retirement planning information from their employers said they made changes in their retirement planning because of that information. Of those, 48% said they began saving more money and 33% said they changed their investment mix.

About a quarter (27%) of the employees surveyed have access to professional investment advice through their employer-provided retirement plans. Of those who used this benefit, 53% said they received specific recommendations on investing their plan assets and seven out of ten of them said they implemented some (57%) or all (13%) of that advice.

Nearly three quarters (72%) of the employees who do not currently have access to employer-provided investment advice indicated that they would be likely to take advantage of this service if it were offered in person. They would be less likely to use the service if it were offered online (50%) or by telephone (34%).

* Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc.

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