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Best Practices

The Importance of Properly Valuing Plan Investments

The Department of Labor holds plan management responsible for proper valuation and reporting of plan investments — even if you use outside investment custodians, asset or fund managers, or other service providers.

Plain and simple, the ultimate responsibility cannot be outsourced or assigned to a party other than plan management. What this means in practical terms is that you must:

1. **Understand what investments are in the plan.**

2. **Understand the pricing methods used by any third party in order to determine if those valuations are reasonable.**

3. **Have sufficient information to evaluate and independently challenge the valuation.**

Ultimately, your valuation process should ensure that you have an adequate understanding of the characteristics of the investments. This includes an understanding of each instrument's terms and conditions, particularly those that pertain to underlying risk exposure, redemption features and terms that impact investment liquidity. At the same time, you'll need to have an understanding of the valuation process to determine if those valuations are reasonable.

Start at the Start

Begin with a thorough review of the monthly trust reports provided by your plan investment trustee or custodian. Ensure that they are complete and accurately report appropriate investment values based on fair value as of the date of the report.

Your investment fiduciary, who is more likely to be familiar with the valuation of these types of assets, can help to determine whether the value reported in the custodian statement represents fair value or contract value. In either case, it is important that you understand how the investment values are determined so you can make your own judgments about the reliability of the information in the reports.

In addition, you will want to inquire as to whether your custodian will provide you with the information necessary to prepare the required financial statement disclosures regarding the valuation inputs (Levels 1, 2 and 3) and techniques used to determine investment values. For investments reported at contract value, you will need to obtain an audited financial statement of the fund, or a statement prepared by the insurance company in order to determine fair value and any related adjustment.

Best Practices for Investment Valuation

The American Institute of Certified Public Accountants has issued a plan advisory, *The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets*, which provides guidance for ensuring that plan investments are properly valued.

These best practices/controls are usually the responsibility of the investment or finance committee of the plan, if there is one. The actual work may be done by the plan administrator or employees of the sponsor within the finance/accounting functions, but the

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Compliance Matters

Handling Hardship Distributions

Ultimately, a hardship distribution can be made from a qualified plan only if all three of the following conditions apply:

1. The plan *permits* hardship distributions;

2. The distributions are used to meet an *immediate and heavy financial need* (as specifically defined by ERISA) of the employee — and in certain cases, the needs of the employee's spouse, dependent or beneficiary; and

3. The distributions are made *only* in an amount necessary to meet the financial need.

Where Plans Get into Trouble

As straightforward as this may seem, plan sponsors often fall short in several basic areas of hardship withdrawal administration. These include:

- **Conflict with plan documents** – For example, a participant requests funds to cover tuition and education expenses, yet the plan only allows distributions to be made for medical or funeral expenses.

- **Inadequate documentation** – As the plan sponsor, you are required to determine whether an employee's request does, in fact, meet the definition of an immediate and necessary expense — and keep proper documentation of your decision. That documentation could include escrow instructions, unpaid bills (medical, tuition, burial expenses, etc.), estimates for repairs due to a natural disaster, or copies of pending foreclosure notices.

- **Failure to suspend contributions** – Most plans also specify that the employee is suspended from contributing to the plan and all other plans that the employer maintains for at least six months after receiving a hardship distribution.

- **Approving excessive amounts** – As plan sponsor, you should also verify that the hardship distribution amount requested does not include more than an employee needs to satisfy the immediate and necessary need.

- **Ignoring limits** – Make sure that the amount of the hardship distribution does not exceed any limits under the plan and is made only from the amounts eligible for a hardship distribution. For example, hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals, and generally don't include any income earned on the deferred amounts.

The Consequences of Hardship Withdrawals

Taxes – Amounts withdrawn are subject to federal and state income taxes and a 10 percent federal excise (penalty) tax. As a result, the net proceeds of the hardship withdrawal can easily be cut by 30-40 percent or more due to taxes and penalties.

Suspension of contributions – The participant must also be suspended from contributing to the plan for a period of six months following the hardship, which will mean no matching contributions from the employer.

Opportunity costs – One of the biggest consequences of taking a hardship withdrawal is the lost opportunity of compounding interest earned over time. Participants could be missing out on tens of thousands of dollars at retirement. ■

Righting the Wrong

In general, a plan can use either the IRS's Self-Correction Program (SCP) or Voluntary Correction Program (VCP) to correct a hardship distribution error. Look for these common mistakes:

Problem: Hardship distributions have been made, but the current plan document does not allow for hardship distributions.

Correction: Make a retroactive amendment to allow for the hardship distributions you made available. Note that the amendment must provide that the hardship distribution option is nondiscriminatory.

Moving Forward: Establish practices and procedures to approve or deny the distribution request. These include specifying what information must be provided to demonstrate a hardship, the procedures the employee must follow, the plan's definition of a hardship, and any limits on the amount and type of funds that can be distributed.

Problem: Hardship distributions are made to participants that don't meet the plan document hardship requirements or the 401(k) rules.

Correction: Correction may involve a repayment to the plan of the amounts that didn't meet the plan hardship requirements or IRC Section 401(k).

Moving Forward: Only allow hardship distributions that meet the plan document and IRC Section 401(k) requirements. The plan administrator should be thoroughly educated in the plan's hardship distribution provisions to ensure that distributions are approved only when permitted by the plan. ■

An experienced accounting professional can help ensure that your plan is in compliance with hardship distribution rules. Call us to schedule a review of your plan.

Valuing Plan Investments

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results of this work are reviewed by the plan oversight entity. As part of this review, the entity should:

- Compare quotation sources and appraisal reports with recorded values.

- Compare values of pooled separate accounts and bank collective investment funds to net asset values calculated by the issuer, and understand the adjustments that were made to net asset values (if any) to arrive at fair values.

- Obtain the financial statements (preferably audited) of pooled separate accounts and bank collective investment funds or any investment whose price is not quoted in an active market (Level 1), and compare unit or other information contained in the financial statements for reasonableness to the unit or other values reported to the plan. Also make sure you understand the adjustments that were made to net asset values (if any) to arrive at fair values.

- Document valuation methods in the trust agreement or plan committee minutes.

- Have the plan committee approve the basis for "good faith" estimates, including independent appraisals (if any) and document the basis used.

- Obtain documentation from pricing services about the pricing methodologies and sources used. In addition to controls at the plan, the trustee and/or custodian should have adequate internal controls over the process used to value plan investments.

Understanding Your Reporting Obligations

Information about your plan's investments must be reported on IRS Form 5500. If your plan has 100 or more participants, you'll generally be required to provide audited financial statements along with your Form 5500.

Plans that have fewer than 100 participants may also be required to include audited financial statements in cases where the plan holds significant amounts of non-readily marketable assets. See the sidebar below for a discussion of the challenges of valuing alternative investments.

Note that plan investments must be reported on Form 5500 at their "current value." However, audited financial statements typically value plan investments at their "fair value" under generally accepted accounting principles (GAAP). Generally, current value and fair value will be the same for actively traded mutual funds and common stocks. However, for collective trust funds, insurance contracts and other alternative investments, "current value" actually represents "contract value."

How the Right Plan Auditor Can Help

An accounting professional experienced in auditing employee benefit plan financial statements can be an invaluable resource. This professional can provide advice and recommendations to assist you in making decisions about the adequacy of your investment valuations. ■

Our accounting professionals can provide the guidance you need to properly monitor your plan's investments. Please contact our office for assistance.

The Murky Matter of Alternative Investments

You'll also want to have in place a process for valuing any so-called "alternative investments" held by the plan, such as private equity funds, real estate funds and insurance accounts. By their very nature, these are investments for which a readily determinable fair value may not exist. Typically, the outside investment manager, the custodian or the issuer of the alternative investment ends up determining a value, which plan fiduciaries simply accept at face value.

The danger here is that the Department of Labor holds plan management responsible for the proper reporting of plan investments. Fiduciaries must have a sufficient understanding of:

- The underlying investments.

- The portfolio strategy of the alternative investment.

- The method and significant assumptions used by the fund manager to value the underlying investments.

Of course, some plan administrators avoid investing in funds where no underlying investment detail is available. But there are steps you can take to gain sufficient understanding of the alternative investment:

- Periodically interview fund managers so that you understand a fund's strategy, positions and valuation methodologies.

- Compare data obtained from the fund manager with other available information, such as sector data, indexes and cash distributions.

- Corroborate this information through the annual audited financial statements of the alternative investment. ■

Challenged by the prospect of valuing alternative investments? Please contact our office for guidance.

Mueller Prost
CPAs + Business Advisors

www.muellerprost.com

MISSOURI
St. Louis (main office)
7733 Forsyth Blvd., Suite 1200
St. Louis, MO 63105
tel: 314.862.2070
fax: 314.862.1549

MISSOURI
St. Charles
2460 Executive Drive
St. Charles, MO 63303
tel: 636.441.5800
fax: 636.922.3139

CALIFORNIA
Long Beach
2010 Main Street, Suite 340
Irvine, CA 92614
tel: 800.649.4838
fax: 562.624.9818

Avoid Missed Handoffs with Your TPA

A third party administrator (or TPA) can prove invaluable in the administration of your plan. But missteps can occur when plan sponsors don't fully understand the TPA's duties and roles.

When you hire a TPA, the IRS still expects you to be ultimately responsible for plan operations. Here are some good steps to take:

- **Know who's doing what.** Start by establishing clear expectations and roles through the service agreement with the TPA. For example, will your TPA be responsible for calculating participants' maximum contribution amounts and for monitoring the actual contributions made each year? Will the TPA communicate new rules regarding plan administration to participants? Keep a copy of the most recent service agreement handy and periodically review it to make certain you know what services your TPA is actually providing.

- **Provide accurate data**. When handling vesting calculations related to employer contributions for participant distributions, TPAs rely on plan administrators to provide accurate workforce data. This means checking HR records to verify each participant's years of service and then verifying the calculation using the vesting schedules in the plan document.

- **Approve loans and distributions.** Often, a service agreement specifies that the plan administrator is responsible for the approval of participant loans and distributions — yet participants may initiate the requests directly with the TPA [typically, when they have web-based access to their 401(k) accounts]. Problems occur when plan administrators assume the TPA has provided approval simply through the act of processing the request.

Bottom line: The plan administrator should review and approve all participant loans and distributions for compliance. This includes obtaining supporting documents for "hardship" distributions and verifying participants' age for "in-service" distributions. ■

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