Pension Plan Fix-It Handbook

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Sponsors using limited-scope audits should watch proposed audit changes

By Mary B. Andersen, CEBS, ERPA, QPA

The American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board (ASB) recently issued a proposed Statement on Auditing Standards (SAS) that will affect all independent qualified public audits of employee benefit plans, especially limited-scope audits.

The 133-page exposure draft, "Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA," was issued April 20. The proposed SAS changes are effective for audits of financial statements for periods ending on or after December 15, 2018.

The AICPA ASB is looking for comments on the proposed SAS. It has identified nine specific issues on which it would like feedback. At present, the deadline for submitting comments is August 21, but it is expected that there will be requests to extend it.

See *Andersen*, p. 7

High court: 'Church plan' doesn't need a church behind it for ERISA exemption

The Employee Retirement Income Security Act (ERISA) generally requires private employers offering pension plans to adhere to a lengthy list of rules designed to ensure plan solvency and protect plan participants. Church plans, however, are exempt from those requirements.

But what, exactly, constitutes a "church plan"?

The U.S. Supreme Court ruled in early June—unanimously—on this issue.

Details of the case

The case involved three church-affiliated nonprofits that run hospitals and other healthcare facilities (collectively, hospitals). These hospitals offer defined benefit (DB) pension plans to their employees. The plans were established by the hospitals themselves—not by a church—and are managed by internal employee benefits committees.

The three hospitals involved in the case were Advocate Health Care Network, associated with the Evangelical Lutheran Church in America and the United Church of Christ; Saint Peter's Health Care System, which is both owned and controlled by a Roman Catholic diocese; and Dignity Health, which maintains ties to the Catholic religious orders that initially sponsored some of its facilities.

See *Church plans*, p. 6

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IRS delay in implementing new mortality tables affects pension liability valuation

The Internal Revenue Service's (IRS) delay until 2018 of implementation of updated mortality tables for pensions gives defined benefit (DB) plan sponsors some extra time to prepare for significant changes tied to increased participant longevity. But the delay also may affect pension liability valuation in up to three ways, according to investment consulting firm Cambridge Associates.

The three areas of pension liability that may be touched by the delay are minimum required contributions, variable-rate Pension Benefit Guaranty Corporation (PBGC) premiums, and lump-sum distributions to terminated vested participants (see related story, Page 3).

In an April client brief about the implementation delay for the 2014 mortality assumptions known as RP-2014, Cambridge Associates said: "Practically speaking, this means that for the remainder of 2017, the liability valuation of these three purposes is temporarily lower (and funded status therefore temporarily higher), than it would be once the new tables are adopted."

History of new tables

The Society of Actuaries on October 27, 2014, released the final RP-2014 mortality tables and the MP-2014 mortality improvement scale for determining participant longevity in pension benefit calculations, updating tables from the year 2000.

The IRS and U.S. Department of the Treasury usually evaluate options for updating the mortality tables as mandated by federal law, and they generally issue proposed regulations to make the changes available for comment before they are enacted. Pension plans then set their own mortality, or "generational," tables based on these underlying life-span assumptions.

One important lesson all DB plan sponsors can benefit from now is that the rules for valuing pension liabilities—and funded status—can be "dramatically" different for different purposes, the Cambridge Associates client brief said.

The brief points out several issues that plan sponsors may have to address soon:

- Contributions to the plan may have to rise. Because funded status determines the level of minimum required contributions, a drop in funded status means higher required contributions must make up the deficit.
- Premiums due to the PBGC may jump dramatically for certain plans because a lower funded status also means higher PBGC premiums.
- Lump-sum distributions may gain attention. Paying out benefits while the plan is underfunded results in a lower funded status in percentage terms, the brief said. Depleting funds means it will be harder to compensate for shortfalls with investment returns.

Sponsors should expect to see their IRS funded status decline in 2018 to roughly the same amount as they saw their accounting funded status decline when RP-2014 was first used on their financial statements, Cambridge Associates said. Generally, a plan's IRS funded status under recent federal rules is significantly higher than for accounting or economic purposes due to the use of a higher liability discount rate.

As for PBGC premiums, which already are on the rise from controversial hikes brought about by the federal laws mentioned above, plan sponsors can expect a "double whammy" in 2018 as a result of variable-rate PBGC premiums. They will face both higher rates per $1,000 of underfunding from the previous legislation and new, greater levels of underfunding due to the IRS adopting the new mortality tables, the investment consulting firm wrote.

See *Mortality tables*, p. 6

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Steps to consider when setting up, administering defined benefit plan lump-sum windows

Lump-sum windows that offer defined benefit (DB) retirement plan participants a chance to convert their vested accrued monthly benefit into a one-time lump-sum cash-out have gained popularity as a way for pensions to "derisk" their balance sheets and lower their headcount for U.S. Pension Benefit Guaranty Corporation (PBGC) premiums.

But setting up these windows can require DB plan sponsors and their third-party administrators (TPAs) to take several preparatory steps. A client bulletin from global actuarial and consulting firm Milliman, which assists with lump-sum window projects, summarizes some of the most important activities for plans that are considering this move.

Most important steps

Among them:

Identify the eligible population—Milliman advises that it's necessary to identify the affected population first. Some questions the firm says to keep in mind include: Will your window be limited to terminated vested participants only? Are you worried that paying a large number of lump sums might trigger a "settlement" that would require special legal or accounting procedures? Milliman says answering these questions early in the process will make it easier to deal with people who are upset that they weren't offered a lump sum.

Clean up the data—Once the eligible population has been identified, the plan must ask how clean its data on the participants are. Missing employment dates and other forms of bad data may cause problems when calculating benefits. Milliman suggests the plan's actuary be involved throughout the planning process, to assist with data issues. It says running participant and address searches using two or more sources can provide a precautionary approach to keeping data current.

Seek legal counsel assistance—Including legal counsel through the lump-sum window process will help resolve matters such as whether there are plan amendments in effect that would interfere with the window or whether a new plan amendment is needed before engaging in the window.

Determine the duration of the window—Once this is known, a deadline needs to be set for participants to take advantage of the window. Plans should be sure that their election packet clearly states the date by which all documents and required forms are to be submitted, qualified, postmarked, and returned.

Deliver an announcement mailing—This preliminary step will ensure that the actual mailing of election packets for the window is not a surprise to anyone. The announcement mailing should include a summary of what to expect, deadlines, frequently asked questions (FAQs), plan contact information, and a phone number for more information. It also may be useful to have a reminder section telling participants to have readily available copies of important documentation if they are considering participating.

Anticipate participant inquiries—After the announcement mailing has been sent out, the plan's call center should be fully prepared to handle participant inquiries on the front lines before, during, and after the closing of the window, the Milliman bulletin says. Their questions may touch on eligibility for the window, required documents, and deadlines. The consulting firm also suggests the phone number given for lump-sum buyout information have a prerecorded message in case of high call volumes.

Create the lump-sum window packet—Milliman in the bulletin contends that the packet is the "biggest contributing factor to ensure the overall success of the program." To start, the firm suggests it be sent in an envelope that captures the participants' attention and includes a return address in case it does not reach the participant. The envelope is especially important if the plan has merged several different companies' pension plans.

See *Lump sum windows*, p. 5

PBGC removes change in credit quality as possible trigger for Early Warning Program review

The Pension Benefit Guaranty Corporation (PBGC) in early May clarified guidance issued in late 2016 about its Early Warning Program (EWP), explaining that the program had not been expanded, and such a review for an employer's defined benefit (DB) retirement plan would not be triggered solely by a change in credit quality.

In the December 2016 guidance (see February 2017 story), the PBGC added for the first time a company's credit deterioration or a downward trend in its financial metrics, such as cash flow, as possible triggers for an inquiry under the EWP.

"In other words, while historically PBGC focused on transactions or events, the December guidance included *trends* in the list of risk identification factors," said a May 11 client bulletin from Groom Law Group.

> The PBGC updated its webpage on risk mitigation and the EWP, removing credit deterioration and a downward trend in company financials as risk identification factors.

Concern about more scrutiny

This change caused consternation and questions from the DB retirement plan community, which perceived the PBGC to be widening its net and adding more scrutiny of companies with pensions, even if the company was considering a corporate transaction or conducting business as usual.

The PBGC on May 10 updated its webpage on risk mitigation and the EWP, removing credit deterioration and a downward trend in company financials as risk identification factors. A frequently asked questions (FAQ) webpage was posted at the same time by the agency that said, "Change in a plan sponsor's credit quality does not trigger an Early Warning Program review."

Yet, the agency made it clear that it usually considers a company's credit quality along with factors such as plan funding in its analysis of a plan that may be showing early warnings of distress. If the plan sponsor has a good credit rating or a potential transaction will not result in a credit rating downgrade, it is less likely that the PBGC will contact the sponsor about the transaction, the FAQ said.

The updates were made in response to stakeholder feedback showing confusion about how the EWP works and when the PBGC is likely to contact plans about an investigation. Although it stated that the update did not change the EWP, the agency said it was intended to "increase transparency to the process," as well as expand the description of the program, and replace outdated references to pension law and terminology.

The FAQ also clarified that the PBGC applies plan participant count and underfunding monitoring criteria on an aggregate controlled-group basis, rather than plan by plan. It continues to focus its monitoring on large plans with underfunding of $50 million or more or 5,000 or more participants.

Existing watch list

- The EWP still includes the following factors in its early warning signs for at-risk company DB plans:
- A change in the group of companies legally responsible for supporting a pension plan (known as a controlled group), including a spin-off of a subsidiary;
- A transfer of significantly underfunded pension liabilities related to the sale of a business;
- A major divestiture by an employer that retains significantly underfunded pension liabilities;
- A leveraged buyout involving the purchase of a company using a large amount of secured debt; *or*
- The payment of a very large dividend to shareholders.

Use of Section 4010 data

The FAQ also said the agency does not use information provided by plans in filings under Section 4010 of the Employee Retirement Income Security Act (ERISA) to open reviews or to trigger an EWP review.

The PBGC further said in the FAQ that the EWP "helps premium payers [in other words, affected DB plans] by avoiding or mitigating loss."

"It should be encouraging to plan sponsors that PBGC disclaimed any prior expansion of the Early Warning Program," the Groom Law Group bulletin said. "However, … sponsors should expect PBGC to continue to pursue Early Warning Program investigations in the context of corporate transactions…."

The federal pension insurance agency has for more than 20 years monitored corporate transactions and events through its EWP. It said its experience has shown that it can avoid terminating a pension plan by working with the plan sponsor to obtain protections before a business transaction significantly increases the risk of loss. ❖

Pension buyouts at highest 1Q level in 15 years, according to LIMRA institute survey results

Single-premium pension buyout sales as part of the "derisking" of defined benefit (DB) retirement plans for the first quarter rose 31 percent from the same period in 2016, totaling $1.4 billion—the highest first-quarter results in 15 years, according to the LIMRA Secure Retirement Institute.

It was only the second time first-quarter pension liability sales to insurance companies have exceeded $1 billion since 2008, the institute said in a May 24 news release. Traditionally, pension buyout sales rise each quarter through the year and are highest in the fourth quarter. The sales reached $13.7 billion for all of 2016. (See January story on 3Q 2016 buyout sales.)

However, the seasonality of pension risk transfer sales seems to be changing. "More recently, the institute has observed broader, more consistent sales. Buy-out sales have surpassed $1 billion for eight consecutive quarters," Matthew Drinkwater, assistant vice president at the LIMRA Institute, said in the release.

Reasons to shed liabilities

Changes in mortality tables that reflect increasing longevity, higher interest rates, and rising Pension Benefit Guaranty Corporation (PBGC) premiums for DB plans all give corporate plan sponsors incentives to consider shedding pension liabilities, as executives perceive that the cost to retain the liabilities outweighs the benefits.

Total assets of pension buyout products were nearly $99 billion at the end of the first quarter of 2017, LIMRA data showed, nearly 11 percent higher than in the first quarter of the previous year.

A group annuity risk transfer allows an employer to transfer all or a portion of its pension liability to an insurer. In doing so, an employer can remove an often-threateningly large liability from its balance sheet and reduce the volatility of the pension's funded status. Single-premium group, or terminal funding, annuity contracts are purchased by an employer that has decided to terminate its DB pension plan and is required by regulation to transfer participants' accrued benefit liabilities into a life insurer's irrevocable group annuity contract.

Funding struggles

Drinkwater said recent research at the LIMRA Institute indicated that 8 out of 10 employers with traditional DB plans are interested in pension risk transfer activities such as buyouts. But roughly the same percentage of DB plans are currently less than 90 percent funded, LIMRA said, which makes their liabilities harder to sell off to the insurance companies that buy them. Several years of low interest rates and volatile financial markets have made it difficult for sponsors to keep DB plans fully funded.

The LIMRA assistant vice president said the Institute expected funded rates to improve as interest rates increase.

The LIMRA institute conducts the Group Annuity Risk Transfer Survey each quarter with participation from the 14 financial services companies that provide group annuity contracts for the U.S. market. The LIMRA institute describes itself as a source of "unbiased research and education" about the retirement industry. ❖

Lump sum windows (continued from p. 3)

Milliman advises using company logos and wording such as "IMPORTANT PENSION INFORMATION" on the envelope as well. The packet's election guide should get right to the point and outline choices in participant-friendly language. A checklist with necessary items and a section with instructions and deadlines (with these repeated throughout the packet) are also part of best practices for lump-sum payouts. Election forms should be single-sided in case they need to be scanned. The bulletin also recommends adding a separate booklet with required legal notices such as an explanation of payment options, disclosure of right to defer distribution, and special tax notice regarding plan payments and rollovers.

Once the window is closed

The bulletin cautions that "[w]eird stuff is bound to happen" once the window has closed. Plans should be prepared for participants who were not accepted into the window pleading their cases, or those who claim they cannot provide complete forms. It also recommends being ready for a participant accepting the lump sum, then dying before the payment is received. Other participants may contest the value of the lump sum shown in his or her election packet. And it may be necessary to recalculate a few lump sums if an incorrect birthdate is supplied, for example.

"Having a template for a detailed calculation worksheet will bring peace of mind when reassuring participants that the amounts are accurate," Milliman states.

In order to minimize administrative error, the plan should have a solid scanning protocol in place. The consulting firm says knowing what to expect will reduce this type of error, confusion, and resending of paperwork by participants. ❖

Church plans (continued from p. 1)

A group of current and former employees filed class actions alleging that the hospitals' pension plans did not fall within ERISA's church-plan exemption because they were not established by a church. The district courts agreed with the employees, ruling that a plan must be established by a church in order to qualify for the exemption; the appeals courts affirmed.

The U.S. Supreme Court, however, ruled 8–0 (Justice Neil Gorsuch did not participate in the case) that a plan maintained by a principal-purpose organization qualifies as a "church plan," regardless of who established it.

Need not be established by a church

Justice Elena Kagan wrote the majority opinion. The definition of "church plan" came in two distinct phases, noted the Court. Initially, ERISA defined it as a "plan established and maintained … for its employees … by a church or by a convention or association of churches." But in 1980, Congress amended the statute to expand the definition. Now, for purposes of the church-plan definition, an "employee of a church" includes an employee of a church-affiliated organization, such as the hospitals in this case.

Congress also added in 1980 a provision providing that the definition of "church plan" includes a plan established or *maintained* [emphasis added] by an entity whose principal purpose is to fund or manage a benefit plan for the employees of churches or church affiliates.

The intent of Congress, the Supreme Court concluded, was to encompass a different type of plan in the definition—one that "should receive the same treatment (in other words, an exemption) as the type described in the old definition." And these "newly favored plans" are described by the Court as those maintained by a "principal-purpose organization," regardless of their origins.

In short, "[b]ecause Congress deemed the category of plans 'established and maintained by a church' to 'include' plans 'maintained by' principal-purpose organizations, those plans—and *all* those plans—are exempt from ERISA's requirements."

Sotomayor opinion

Justice Sonia Sotomayor, in a concurring opinion, noted that the majority opinion meant that "scores of employees—who work for organizations that look and operate much like secular businesses—potentially might be denied ERISA's protections. In fact, it was the failure of unregulated 'church plans' that spurred cases such as these."

While Sotomayor joined the majority opinion because she was "persuaded that it correctly interprets the relevant statutory text," she was nonetheless "troubled by the outcome of these cases."

She noted that while Congress acted in 1980 to exempt plans established by orders of Catholic sisters, "it is not at all clear that Congress would take the same action today with respect to some of the largest health-care providers in the country … organizations [that] bear little resemblance to those Congress considered when enacting the 1980 amendment…."

The case is *Advocate Health Care Network v. Stapleton, U.S. Supreme Court 581 U.S. ____ (June 5, 2017).* ❖

Mortality tables (continued from p. 2)

At the same time, the reality of increased longevity and longer-term retirements may lead some employees to work beyond a pension plan's "normal retirement age," offsetting somewhat the increased liabilities brought about by the latest mortality assumptions.

Uses for mortality tables

Among other things, mortality tables are used to figure a DB plan's minimum funding requirements, or targets, as required by federal regulations. The Pension Protection Act of 2006 (PPA) established a minimum funding ratio of 80 percent (pension assets divided by liabilities) in most cases. The tables also let plan sponsors establish present value requirements each year. The net present value of individuals' pensions calculates their value in current dollars. Net present value accounts for the fact that the payments will be spread out over several years and could be invested and paying a return in that time period.

The regulations that govern the use of the new mortality tables by DB plans allow plan sponsors to apply the projection of mortality improvement in one of two ways: through use of static tables like the ones released July 31, 2015, or through use of generational tables, the IRS said.

"Sponsors should ensure that they are equipped with a comprehensive pension strategy that encompasses both funding and investment policies," as well as potential "derisking" options ahead of 2018 IRS implementation of the altered mortality tables, Cambridge Associates recommended. ❖

Andersen (continued from p. 1)

Background

Our May 2015 column discussed a report from the U.S. Department of Labor's (DOL) Employee Benefit Security Administration (EBSA) regarding the quality of the Employee Retirement Income Security Act of 1974 (ERISA) audit work. The EBSA report found that almost 40 percent of employee benefit plan audits were deficient. It said that the quality of audits could be directly related to the number of audits conducted by a CPA firm. The firms that performed the least number of audits had a higher deficiency rate, while the CPA firms that performed the most audits had the lowest deficiency rate.

The EBSA report findings may have been a key factor contributing to the DOL request to the AICPA that it revisit the format of the employee benefits plan auditor report. However, the limited-scope audit has been under the microscope as far back as 2012 (see January 2013 column), when an Office of the Inspector General (OIG) recommended repeal of the limited-scope audit.

The option for a plan to conduct a limited-scope audit arises from ERISA Section 103(a)(3)(C), which lets the plan administrator exclude from review by its independent auditor statements prepared by a bank or similar institution or insurance carrier that is regulated and supervised by a state or federal agency. This provision allows the auditor to rely on statements prepared by such institutions if the statements are certified as "complete and accurate."

In a limited-scope audit, the auditor still is required to test for ERISA and federal tax Code compliance in all significant audit areas, such as contributions, benefit payments, participant loan processing, hardship distributions, participant data, eligibility to all plan features, and payroll (see June 2014 column). The extent of the audit procedures applied to each plan will vary, depending on the risk level assessed by the auditor.

While the proposed SAS will affect full-scope audits to some extent, its biggest impact will be on limited-scope audits. DOL regulation Section 2520.103-8 allows a plan to exclude from the audit any statement or information regarding plan assets held by banks, similar institutions, or insurance carriers if the statement or information is prepared and certified by one of those entities. The proposed changes alter the form and content of the limited-scope audit.

This column addresses some of the proposed changes to the limited-scope audit.

When a limited-scope audit is requested

In a limited-scope audit, the auditor performs audit testing on information not covered by the certified information. The proposed SAS would require that the auditor:

- Read the certification prepared by the financial institution;
- Evaluate management's assessment of the certification;
- Compare the certified investment information to the plan financials and, to the extent they do not match, require additional audit procedures; *and*
- Decide whether the plan financial statements are in accordance with the applicable financial framework.

Note: In an employee benefit plan audit, the auditors examine plan financial statements prepared by the plan sponsor. In a limited-scope audit, the auditor does not test the certified information provided by the financial institution. The 2012 DOL OIG report noted that in 2010, more than 70 percent of plan audits were limited-scope audits and that the statements provided by the financial institutions certify that the statements are complete and accurate as to holdings, but not to value.

The SAS expects the auditor to obtain an understanding of the types of investments and the methodology for measuring the investments. Plan management would be required to be able to explain how investments are valued, how they are classified on the financial statements, and whether the investments are presented in accordance with applicable financial requirements.

Written representation by management

The auditor will request written representation from plan management that indicates that management has:

- Provided the most current plan document, including amendments;
- Acknowledged its responsibility for administering the plan and that the plan transactions presented in the financial statements are in accordance with the plan provisions, including availability of plan records necessary to determine benefits payable;
- Acknowledged responsibility for preparing the financial statements;
- Determined that a limited-scope audit is permissible;
- Evaluated that the certified information is complete and accurate; *and*

See *Andersen*, p. 8

Andersen **(continued from p. 7)**

- Determined that the investment information is presented in accordance with the applicable financial reporting framework.

Bottom line: The proposed SAS requires the plan sponsor to acknowledge its responsibility when it comes to the audit. The auditor would be required to get it in writing.

Increased auditing

Auditors generally seek to determine the materiality of a particular issue when determining the amount of testing performed. The SAS would require "substantive procedures" for certain plan provisions, regardless of materiality. These procedures include an evaluation that plan document terms have been followed in determining:

- Eligibility;
- Benefit payments;
- Vesting;
- Contributions;
- Appropriate reporting in supplemental financial statements of any prohibited transactions;
- Expense allocation;
- Assets are fully allocated to participant accounts;
- Forfeiture use; *and*
- Correct recording of participant account activity.

In addition, the auditor would be expected to perform audit procedures related to the various Internal Revenue Code (IRC) nondiscrimination tests (for example, coverage, 401(k) nondiscrimination, top-heavy status, annual additions, 402(g) limits on deferrals, and minimum funding).

The auditor must evaluate the results, determine the effect on the plan's financial statements, and indicate any internal control deficiencies. The exposure draft includes model language regarding specific plan-provision testing for the auditor to include in the audit report.

Proposed exposure draft

Requiring plan sponsors to acknowledge their responsibility concerning employee benefit plan audits is not a bad thing, as many sponsors are unaware of the extent of their responsibility. This change will most likely increase plan sponsor costs, especially when plan sponsors opine on certified financial statements prepared by financial institutions. Plan sponsors may need to engage the appropriate subject matter expert to comment on asset valuation and financial statement presentation.

Specific plan provision testing might lead to plan sponsors' conducting more frequent internal compliance reviews before an audit begins and result in a stronger focus on and adherence to compliance obligations.

However, the amount of auditor testing and reporting on plan administrative procedures could be problematic when attached to the auditor's opinion, which is provided with the annual Form 5500 filing. The regulations are complex, and errors are bound to happen. If an auditor finds something, includes it in the audit report, and it is an error that can be corrected under the Internal Revenue Service's (IRS) Employee Plans Compliance Resolution System (EPCRS), it raises red flags unnecessarily. In addition, plan administrative errors reported in the audit report could be data-mined by competitor service providers and used as an entrée to "poach" contracts for administrative work.

It is unclear if requiring specific plan testing on issues not determined to be material by the auditor will provide any benefit. It is clear that additional testing will increase the cost of the audit.

If the deficiencies uncovered in EBSA's report were the main impetus for the exposure draft, time will tell if the additional procedures and management representations improve audit quality. The changes could lead to smaller CPA firms walking away from employee benefit plan audit work. They also could increase the frequency of deficient audits because there are more required steps.

Key takeaway for plan sponsors

Plan sponsors are advised to:

- Read the exposure draft, especially if using a limited-scope audit, and discuss its ramifications with their auditors;
- Conduct internal compliance review and avoid any potential airing of "dirty laundry," should the specific plan-provision testing requirements remain in the exposure draft. They also should ensure that well-documented procedures and controls exist and are being followed;
- Talk to service providers and internal staff about any past errors, and confirm that appropriate procedures and controls have been implemented to prevent the recurrence of errors; *and*
- Revisit the details of any service agreement to ensure that roles and responsibilities are clearly defined.

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