TESTIMONY OF
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BEFORE THE ERISA ADVISORY COUNCIL

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I am pleased to appear before the ERISA Advisory Council on behalf of the American Institute of Certified Public Accountants for which I serve as a member of the Employee Benefit Plan Audit Quality Center Executive Committee. The Employee Benefit Plan Audit Quality Center is a firm-based voluntary membership center with nearly 2,300 CPA member firms that audit employee benefit plans.

We applaud the Council's focus on connecting missing and lost participants (hereinafter referred to as "Lost Participants") with their benefits. The Council's Issue Paper observes that plan representatives, including their accountants, regularly face accounting issues involving Lost Participants. These include how to account for amounts due Lost Participants or held by a third party administrator to pay claims to lost participants in employee benefit plans, and the treatment of retirement plans that are intended to be treated as terminated but the final distribution of assets is not possible due to Lost Participants.

In my remarks today I will discuss the accounting and auditing issues associated with Lost Participants. Specifically, I will focus on plan accounting and auditing considerations related to unclaimed benefits and uncashed benefit checks. I also will discuss these issues for plans that have terminated or are terminating. I will not address the tax, legal or fiduciary responsibility aspects of Lost Participants.

I also will provide recommendations for the Council to consider in addressing these issues.

To begin, I will summarize the situations in which a plan participant may be considered "lost":

a. The plan administrator cannot locate a participant in an active or terminated plan who is eligible to receive benefits or distributions but has not requested a benefit payment (*unclaimed benefits*).

b. The plan administrator cannot locate a participant to whom a benefit payment was sent (or to whom an automatic distribution of a terminating participant's account balance of less than $1,000 was made) and the check is not cashed (*uncashed benefit checks*).

While the Department of Labor (DOL) has issued guidance outlining fiduciary duties under ERISA related to Lost Participants, and has provided a safe harbor for sponsors to make rollover distributions into IRAs for Lost Participant balances of $5,000 or less, there is no definitive guidance on when a distributed benefit ceases to be a plan asset or how plans should account for plan benefits and related assets for Lost Participants (or known participants who simply do not cash their benefit checks.) As a result, there continue to be questions and inconsistencies in the plan sponsor community about how unclaimed benefits and uncashed checks should be accounted for in the plan's accounting records, and reported on the Form 5500 *Annual Report* and in the plan's financial statements.

Historically, the total dollar amount of unclaimed benefits and uncashed benefit payment checks in employee benefit plans generally has not been what auditors would consider "material"—a concept that I will discuss later in my testimony. However, the trends toward plans providing for automatic enrollment in 401(k) plans, employees holding multiple jobs during their careers and leaving their retirement accounts with their ex-employer when they change jobs, and employers' automatic distributions of former employee account balances of less than $1,000, are contributing to an increase in the amount of unclaimed benefits and uncashed benefit checks.

As a result of these trends, the amount of unclaimed benefits and uncashed checks has become quite large in some plans, and there is an increasing likelihood that the amounts will continue to increase in even more plans. This creates accounting challenges for plan administrators and potential issues for financial statement auditors. I will discuss these later in my testimony.

But first, I will highlight some general challenges regarding Lost Participants to provide context for my remarks about accounting and auditing issues related to Lost Participants.

<u>General Challenges Related to Lost Participants</u>

A plan sponsor's inability to locate Lost Participants can impair effective plan administration. For example, a 401(k) plan sponsor is unable to provide Lost Participants with required annual investment related information, or information that assists plan participants in directing their investments when there is a change in service provider. In addition, sponsors of plans that hold insurance contracts, such as 403(b) plans, may be unable to terminate a contract without the participant's election. In a terminating or terminated plan, the sponsor cannot make a distribution or, where required, obtain authorization for a distribution, if they are unable to locate the participant.

Plans may encounter situations where participants and beneficiaries do not cash benefit checks—because they never receive the checks or the checks are lost, or for whatever reason they simply choose not to cash the check. Uncashed checks in a benefit plan can present unique challenges. Whereas a company can simply void stale uncashed checks and adjust the cash and accounts payable balances on their books and then reissue the check, for various reasons the situation for the sponsor of a benefit plan is not as straightforward. And, as I will discuss later, the plan sponsor may not even be aware that participants or beneficiaries have not cashed their benefit checks. Uncashed checks may go undetected indefinitely or until there is a significant plan change, such as a change in service provider or plan termination.

I will now explain some of the more typical arrangements of how benefits are paid and how uncashed benefit checks related to Lost Participants create challenges for the plan sponsor.

Benefits Paid from Trustee Account

Plan benefits may be paid from the trustee's bank account, which is not a part of the plan's accounting records. However, even when the benefits are paid from an account of the trustee, the amount paid is immediately deducted from plan assets. The trustee may use either of the following arrangements:

a. Benefits are paid from an omnibus bank account of the plan trustee. The trustee writes benefit payment checks from a single omnibus account for all plans for which the bank serves as the trustee, whether or not the plans are affiliated.

b. Benefits are paid from an individual plan bank account managed by the plan trustee. The trustee writes benefit payment checks for an individual plan from an account separate from the plan trust.

In these benefit payment arrangements, the plan trustee often does not provide the plan sponsor with any information about outstanding benefit checks until they become stale, at which time the trustee may return the funds to the plan sponsor. But in some cases the trustee does not return the funds and does not inform the plan sponsor that there are stale uncashed checks, so the plan sponsor may not be aware they exist. Unless the plan sponsor thinks to ask whether there are uncashed checks, the plan sponsor will not be aware of their existence.

And where trustees use omnibus accounts to make benefit payments, there is even greater likelihood the plan sponsor will be unaware of uncashed checks. The trustee may be unable to identify which stale outstanding checks relate to which plan. In that case, the plan sponsor is unable to determine the amount of the plan's stale uncashed checks. We have recently seen that more trustees are providing uncashed check reports, adding the uncashed check balance to plan assets as forfeitures, and providing service agreement addendums outlining how uncashed checks are handled. However, this does not yet seem to be the norm.

Benefits Paid from Plan Sponsor's Payroll Account

Benefits may be paid from the plan sponsor's payroll bank account. The plan sponsor writes benefit checks directly from a payroll or payroll-type system, and deducts those amounts from plan assets. The plan sponsor may receive account statements and is aware there are outstanding checks but may not be aware they relate to the benefit plan and not employee payroll. This is especially true in arrangements when the plan sponsor account is reimbursed by the plan. In these arrangements it may be unclear where the outstanding checks are residing or where they should be recorded.

Terminating or Terminated Plans

As I mentioned earlier, the first time a plan sponsor becomes aware that the plan has stale, uncashed benefit checks may be when the plan is terminating. The plan cannot fully and legally be terminated until all plan assets have been distributed. The first step to address uncashed benefit checks typically is for the plan sponsor to contact the participants and reissue the checks.

If the plan has Lost Participants the sponsor is unable to do this and therefore is unable to complete the plan termination.

Accounting Considerations Related to Lost Participants

Plan administrators face several accounting challenges with Lost Participants, including how plans should account for unclaimed benefits and uncashed benefit payment checks of Lost Participants in the plan's accounting records, on the Form 5500 and in the plan's financial statements.

Unclaimed Benefits

Unclaimed benefits, where the participant is eligible to receive benefits but does not request them, do not create an accounting issue per se. This is because the assets remain in the plan and continue to be reported in the plan's financial statements as net assets available to pay benefits. In a defined benefit plan the amount of unclaimed benefits is included in the total benefit obligation reported in the plan's accumulated benefit obligations. In a defined contribution retirement plan, no benefit obligation is recognized as the benefit the participant ultimately will receive is based upon his or her vested account balance at the time of payment.

Uncashed Checks

Accounting issues may arise in situations where participants and beneficiaries do not cash benefit checks. Further, for reasons previously noted, the plan sponsor may not be able to determine the amount of uncashed checks. As I noted earlier, there is inconsistency in accounting practice because no specific accounting guidance currently exists to determine when a distributed benefit ceases to be a plan asset and how to account for a plan's uncashed benefit checks.

As permitted by the DOL's *Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974 Automatic Rollover Safe Harbor* rule (safe harbor rule), certain Lost Participant retirement plan account balances (of $5,000 or less) can automatically be rolled over into IRAs on behalf of a participant who has separated from service. However, in situations involving leased employees, transient workers, or where the participant has been "lost" for a significant period of time, failure by the plan administrator to maintain participant data (e.g., social security number) may preclude the plan from taking advantage of the safe harbor rule. And it is our understanding that ERISA typically does not permit Lost Participant balances in an ongoing plan to be escheated to the state.

Some defined contribution pension plan documents specify that stale uncashed checks should be brought back into the plan as forfeitures. Depending on the plan document, forfeitures may be used to pay plan expenses, offset future employer contributions, reinstate the previously forfeited account balance of a terminated employee when that participant is rehired within a specified period of time, or may be allocated to the remaining participants. However, in the situation where Lost Participants' uncashed checks are brought back into the plan as forfeitures, those Lost Participants still have a right to their benefits. In this case, the question arises as to how or whether the plan administrator should account for the plan's continuing obligation to pay benefits to Lost Participants who may be subsequently located. Practice is inconsistent in this area. Some plans record a liability to reflect the benefits payable to those Lost Participants.

If uncashed checks are not brought back into the plan as forfeitures, it is unclear how they should be recorded. Again, practice varies in this area. For example, some defined contribution retirement plans reinstate participant accounts for the Lost Participants. In situations where Lost Participants' benefit checks have been outstanding for several years and the plan sponsor no longer maintains the data necessary to restore the account balances of those Lost Participants who are subsequently located, it may not be possible to reinstate those accounts.

Practice also varies in how defined benefit pension plans account for benefit obligations related to Lost Participants. Some reestablish a benefit obligation for those Lost Participants whose checks go uncashed, while others consider the obligation fulfilled when the benefit check was cut.

Terminating or Terminated Plans

Terminating plans also can take advantage of the DOL's safe harbor rule and roll over Lost Participant retirement plan account balances of $5,000 or less into IRAs. In addition, while ERISA does not allow plans to escheat to states Lost Participants' account balances in an ongoing plan, DOL Field Assistance Bulletin 2004-02 does allow plan fiduciaries to consider transferring missing participants' account balances to state unclaimed property funds in the state of each participant's last known residence or work location, if that state accepts such distributions on behalf of Lost Participants. Those transfers from a terminated defined contribution plan to a state's unclaimed property fund would constitute a plan distribution, which ends both the property owner's status as a plan participant and the property's status as plan assets under ERISA.

However, in situations where the plan cannot use the safe harbor, or where participant account balances exceed $5,000 and the state does not escheat participant account balances, the plan termination cannot legally be finalized until those plan assets have been distributed. As such, it is unclear what the plan sponsor's responsibility is for maintaining plan books and records related to Lost Participants whose uncashed checks cannot be rolled over into IRAs or escheated to the state.

<u>Auditing Considerations Related to Lost Participants</u>

I will now discuss the auditing considerations related to Lost Participants.

Audit Objective/Materiality

The independent CPA's overall objectives in a plan financial statement audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. The plan auditor has no responsibility to locate Lost Participants.

Financial statement audits are guided by two important factors: reasonable assurance and materiality. The independent auditor applies materiality considerations in planning and performing the audit, in evaluating the effect of any identified misstatements, and in forming the opinion included in the auditor's report. The determination of materiality is a matter of professional judgment and is based on a combination of both quantitative and qualitative factors. Inherent in reaching judgments about materiality is the auditor's perception of the needs of users of the financial statements.

As I noted previously, the total dollar amount of unclaimed benefits and uncashed benefit payment checks in benefit plans historically has not been material. However, these amounts have become increasingly material for some plans and there is an increasing likelihood that the amounts will become material to more plans. Plan auditors need to consider the potential that these amounts may be material to the plan when planning and performing the audit and in forming their opinion on the plan's financial statements.

The 2013 AICPA Audit and Accounting Guide, *Employee Benefit Plans*, suggests that the auditor may wish to consider inquiring of plan management about any omitted balances that may be held by the plan sponsor, trustee, custodian, or third-party administrator.

Unclaimed Benefits

Unclaimed benefits do not create an auditing issue per se because, as I mentioned earlier, the assets that will be used to pay benefits to those participants remain in the plan and are reported in the plan's financial statements as net assets available to pay benefits. Further, the related benefit obligation is reported in the plan's statement of benefit obligations. Generally, no audit special procedures are necessary to test the assets and obligations related to Lost Participants.

However, the auditor needs to consider the greater potential for fraud in the accounts of Lost Participants in 401(k) plans. Because those participants are not receiving statements, they are unable to determine whether unauthorized distributions are made from their accounts.

Uncashed Checks

Now I will highlight auditing issues that may arise related to uncashed checks, including the need for the plan to establish proper internal controls and the potential increased risk of fraud.

As part of the plan audit the auditor obtains an understanding of the plan's internal control over the financial reporting process and evaluates its effectiveness in order to assess the risks of material misstatement. The lack of internal control to identify and monitor uncashed checks may be considered a material weakness, significant deficiency, or deficiency that the auditor is required to communicate to plan management.

It is increasingly important for plan administrators to have internal controls in place to identify and monitor uncashed checks so they are handled in accordance with the plan document and established administrative procedures, and properly reported in the plan's accounting records. These controls typically include periodically obtaining an uncashed check detail report from the trustee or custodian and monitoring compliance with established administrative procedures to locate Lost Participants.

Uncashed checks may pose a potential fraud risk, especially in situations where the plan sponsor is not aware of their existence. While the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the plan and plan management, the auditor is required to perform certain procedures to identify and assess the risks of material misstatement due to fraud and to design procedures responsive to the assessed risks of material misstatement due to fraud. Auditors may need to consider the fraud risks associated with uncashed checks when they conduct their audit planning and fraud brainstorming sessions, in their consideration of internal control over financial reporting, and as they design and perform substantive audit procedures.

In addition, the situation I described earlier where the plan does not maintain records related to leased employees, transient workers, or participant who have been "lost" for a significant period of time may result in a scope limitation for the plan auditor. A scope limitation could result in the auditor issuing a disclaimer of opinion, which generally is not acceptable to the DOL.

Terminating or Terminated Plans

Earlier I noted that it is unclear what the plan sponsor's responsibility is for maintaining plan books and records related to Lost Participants of terminating plans whose uncashed checks cannot be rolled over into IRAs or escheated to the state. In those situations where there are more than 100 participants who have not cashed their benefit checks, it also is unclear whether the plan would require a financial statement audit.

<u>Recommendations</u>

- The Department should issue guidance clarifying whether uncashed checks are considered plan assets under ERISA. If it is determined that uncashed checks are in fact plan assets, the Department should issue guidance requiring that the plan administrator maintain adequate plan records related to the Lost Participants with uncashed checks.

- The Department should issue guidance clarifying how unclaimed benefits and uncashed checks should be reported in the Form 5500.

- The Department should clarify the plan sponsor's (fiduciary) responsibility for following up on unclaimed benefits and uncashed benefit checks.

- The Department should educate plan administrators about the importance of having internal controls in place to identify and monitor uncashed checks so they are handled in accordance with applicable laws and regulations, the plan document, and established administrative procedures.

- The Department should educate plan administrators about the need to periodically request from the plan's trustee a list of the plan's uncashed checks.

Conclusion

Thank you for your interest in this important matter and the opportunity for me to testify before the ERISA Advisory Council today.

I will be happy to answer any questions.

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