



## The One About the Audit Requirement for Form 5500

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Central Perk Restaurant, Inc. ("Central Perk") is a gourmet restaurant chain with locations in major metropolitan areas across the country. Monica, the owner of Central Perk, has been the plan administrator for the Central Perk Retirement Plan (the "Plan") for the past four years. In 2019, Monica hires a new third-party administrator ("TPA") firm run by Chandler Bing, a very capable TPA.

Forms 5500 are typically due on the last day of the seventh month following the end of the plan year which, for calendar year plans, is July 31<sup>st</sup>. Monica hired Chandler in mid-July. Chandler, knowing he'd need time to prepare the Form 5500 draft, had Monica file a Form 5558 with the Internal Revenue Service ("IRS") to extend the Form 5500 filing deadline to October 15<sup>th</sup>. On October 5<sup>th</sup>, he e-mails Monica, attaching her Form 5500 draft, and tells her it's ready for her auditor to review. Monica, confused about the reference to an auditor, calls Chandler for clarification.

**Monica:** Hey, Chandler. Thanks for sending over the Form 5500 draft. You know that I don't need one of those accountants, right? My former TPA told me it's not necessary. My brother, Ross, is good with numbers. He always looks at the financial statements in my report before I file it. It's worked for me so far. I'm going to stick with him instead of paying accountant fees.

**Chandler:** Ummm, could you *be* any more wrong?? You need an independent qualified public accountant to audit your plan. You didn't need one before but you need one now for 2019, because of the Plan's increased number of participants. Didn't your former TPA explain all of this to you?

**Monica:** He most certainly did not. I thought he was a competent guy. My friend, Phoebe, owner of Smelly Cat Records, recommended him. I only hired you because he left the TPA business for an acting career. I'm going to kill that Joey Tribianni! This is not good, Chandler. Had I known, of course, I would've had the Plan properly audited. What do I do now!?

**Chandler:** Hire an independent qualified public accountant ASAP! S/he and I will take it from there and hopefully we'll make the deadline.

It is clear that Monica was woefully misinformed about when and why she needs an Independent Qualified Public Accountant (“IQPA”) to audit her plan. Here are the important things she needs to know for now and for the future.

### **Why do annual reports for employee benefit plans (Forms 5500) have to be audited?**

Almost every answer to an employee benefit law question is: because it’s in the best interest of the participant. Congress intended (and the courts reinforce) that the Employee Retirement Income Security Act (“ERISA”), which governs retirement plans, be a highly protective statute. According to the Department of Labor (“DOL”) website, the Form 5500 Series is part of ERISA’s overall reporting and disclosure framework, which is intended to assure that employee benefit plans are operated and managed in accordance with certain prescribed standards and that participants and beneficiaries, as well as regulators, are provided or have access to sufficient information to protect the rights and benefits of participants and beneficiaries under employee benefit plans. The information in the reports includes financial statements, books, and other records of the plan. Under ERISA, it is a plan administrator’s duty to give auditors access to these financial statements and books to ensure that they are fairly presented in conformity with generally accepted accounting principles (“GAAP”).

### **Who Is Authorized to Audit the Form 5500?**

Section 103 of ERISA requires that an IQPA audit annual reports. Specifically, an IQPA is defined as:

- A person who is a certified public accountant, certified by a regulatory authority of the State;
- A person who is a licensed public accountant licensed by a regulatory authority of a State; or
- A person certified by the Secretary (of the DOL) as a qualified public accountant in accordance with regulations published by the Secretary for a person who practices in states where there is no certification or licensing procedure for accountants.

If your auditor does not fall into one of these three categories, run the other way. Furthermore, make sure that the IQPA you choose is following the American Institute of Certified Public Accountant (“AICPA”) guidelines. The guidelines cover an extensive number of topics including but not limited to:

- Terms of engagement
- Quality control procedures for an audit of financial statements
- Audit documentation
- Consideration of fraud
- Assessing the risks of material errors in financial statements

### **IQPAs Are Your Friends. (Pun intended)**

Good friends are the ones who keep you out of trouble. Consider IQPAs to be that type of friend. They alert you if your annual report is deficient and, by extension, save you lots of money in the long run. IQPAs find all kinds of issues that, if not for their audit, may have not been found by the plan administrator. Such issues include: irregular or untimely deposits of employee deferrals, fraud or embezzlement, unauthorized distributions, and fiduciary breaches. If these issues are left uncorrected, the annual report will be rejected and subject to steep penalty fees. The recently enacted SECURE Act increased IRS penalties for late or deficient filings *ten-fold*. The IRS’s

penalty for late or deficient filing of a Form 5500 report went from \$25 per day, up to a maximum of \$15,000, to \$250 per day up to a \$150,000 maximum. The DOL's penalty for late filing can run up to \$2,233 per day, with no maximum. Believe it or not, both of these penalties may apply simultaneously.

IQPA fees are worth paying in lieu of DOL and IRS penalties. The plan sponsor can pay the IQPA's fees from general assets or, even better, their fees can be paid by the plan's assets. If paid by the plan, the Form 5500 must disclose the cost of the audit as an expense incurred by the plan.

### **Do All Annual Reports Have to Be Audited?**

No. There are three types of annual reports in the Form 5500 series: 5500, 5500-SF, and 5500-EZ. Form 5500-EZ is a very limited form for plans of closely held companies that cover only business owners and their spouses, are filed only with the IRS (and are not within the jurisdiction of the DOL), and are not required to be audited.

Usually plans with 100 or more participants at the beginning of the year must file Form 5500 (and have an audit), and plans with fewer than 100 participants at the beginning of the year file Form 5500-SF (and don't have to get an audit). There are, of course, exceptions.

First, the "80-120 Rule" may prevent a plan that has more than 100 participants but fewer than 120 participants from needing to be audited. (More about that below.)

Second, plans with fewer than 100 participants must be audited if less than 95% of the plan's assets were invested in certain secure, easy to value assets that meet the definition of "qualified plan assets" – generally, bank accounts, insurance contracts, mutual funds held by a financial institution, participant loans, and employer securities. As an alternative to this requirement, the plan may avoid needing an audit report by increasing its fidelity bond to fully cover all plan assets that are not qualified plan assets.

There are some additional requirements to qualify for the audit waiver, such as special language for the plan's Summary Annual Report and information that must be available to participants upon request. These additional requirements can be found at Labor Regulation 2520.104-46.

### **Tell Me More About the 80-120 Rule.**

Determining a plan's size for purposes of filing Forms 5500 and 5500-SF isn't exactly cut and dried. Generally, a report filed for a pension benefit plan with fewer than 100 participants at the beginning of the plan year must follow filing instructions for a "small plan," and a report filed for a plan with 100 or more participants at the beginning of the year follows filing instructions for a "large plan."

The 80-120 Rule provides that, if the plan was eligible and filed as a small plan for the prior plan year, and did not cover more than 120 participants at the beginning of the plan year currently being filed, the plan may continue to file as a small plan using Form 5500-SF, assuming it meets all other requirements. One of the benefits of the 80-120 Rule is an exemption from the audit requirement.

Let's use Monica's plan as a practical example. The Central Perk Retirement Plan had 60 participants in 2016, its first year. Because it had fewer than 100 participants (and met all the

other above-mentioned requirements), she was allowed to file a Form 5500-SF without an audit report attached. In 2017, the participant count rose to 105. Under the 80-120 Rule, Monica could still file a Form 5500-SF without an audit report attached, because she had fewer than 120 participants and filed Form 5500-SF in the prior year. In 2018, the participant count rose to 115. The 80-120 rule still applied, so she was able to file another Form 5500-SF without an attached audit report. In 2019, however, the participant count rose to 130. Once the participant count goes over 120, the Form 5500 must be filed and the audit requirement applies for all subsequent years for as long as the Plan's participant count remains over 100.

## **Going Forward**

Monica needs to find an IQPA and ERISA counsel ASAP. The IQPA will audit her Form 5500 and draft an opinion. If the opinion is unqualified, then the Plan's financial statements fairly present its financial condition and will likely be accepted by the DOL. If the IQPA's opinion is qualified, has a disclaimer, or is adverse, then the annual report is likely in danger of being rejected by the DOL. Monica's ERISA attorney will coordinate with the IQPA to avoid an adverse opinion. If the DOL rejects the annual report, ERISA allows Monica 45 days from the date of the DOL notice to revise and resubmit it.

## **What About 2019, When Monica Is So Close to the Deadline and the Audit Is Not Done?**

As you may recall, Monica is very close to the Form 5500 due date and hasn't even hired an accountant to perform her audit. Can the Form 5500 be filed in its entirety in time?

Probably not. It takes some time to retain an auditor and for the auditor to do his or her work and prepare the report.

Monica has two choices. She can file an incomplete Form 5500— that is, without the audit. In that scenario, it is likely that the DOL will either reject the filing or advise her within a few weeks that her filing was insufficient. In that case, the DOL will give Monica a limited amount of time to provide the audit report or face penalties. Those penalties can be very expensive – up to \$50,000 – and the DOL will generally not put the process “on hold” while the audit is being secured. (As an aside, if you are in this circumstance, you must hire ERISA counsel quickly; the ability to get these penalties abated is rapidly eliminated if you get too far into the DOL's process without resolution.)

The second option is to hold off filing anything until the audit is complete, and then file the Form 5500 with the completed audit report using the DOL's Delinquent Filers Voluntary Correction Program. Under that program, the employer pays a significantly reduced penalty for the late filing. Unfortunately, Monica's eligibility to use this program evaporates if the DOL advises her that it has not received the Form 5500. However, usually this type of notice is much later to come than a notice of insufficient filing; so this process usually buys Monica more time to resolve the problem before incurring penalties.

How to proceed is Monica's choice, and she should understand the pros and cons of both options before making her decision. Again, ERISA legal counsel help is probably a good idea, and will enable Monica's response to Joey's “How you doin'?” to be much more positive in the future.



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