

Investment Risk & the Labor Union Plan: The Auditor's Perspective on Best Practices For Plan Fiduciaries



April 2009

Mitchell & Titus Headquarters
One Battery Park Plaza
New York, NY 10004
(212) 709-4500
inquiries@mitchelltitus.ey.com
www.mitchelltitus.com

Sponsored by

 **Mitchell & Titus**

A member firm of Ernst & Young Global Limited

Contents

Executive Summary.....	Page 1
The Framework for Investment Due Diligence.....	Page 2
The Keys to Investment Oversight.....	Page 3
Assessment of Risk in Hard-to-Value Investments.....	Page 4
Conclusion.....	Page 5

Executive Summary

The sharp market downturn and investment scandals of 2008 make it clear for labor union plan trustees to pay closer attention to the best practices related to investment due diligence. The investment manager plays a significant role in the disposition of plan assets. The fiduciary responsibility of trustees requires a strong grasp of the control environment established for the labor union's benefit plans. While the plan's auditor cannot offer investment advice, they play a critical role in advising trustees as to the risk factors and control methods needed to ensure the health of plan investments. **Mitchell & Titus LLP** audits over 200 employee benefit plans annually. Our expertise and knowledge of the trustee's responsibilities translates into a strong awareness of the best practices needed for mitigating investment risk, preventing fraud, and complying with regulatory and ERISA requirements.

The precipitous decline in the stock market and the added blow of financial scandals in the investment realm demand a reassessment of the risk management approach and control strategy for plan trustees and investment managers. The uncovering of Bernard Madoff's investment fraud has impacted the labor union plan realm. The pension and health care fund for Syracuse, New York-based United Association Plumbers & Steamfitters Local 267 is listed as a victim in the Madoff's Ponzi scheme.¹ The exposure for labor union health and benefit plans is clear. The individuals entrusted with investment decisions, whether they are in-house plan fiduciaries or a third party administrator, must be stringently monitored and assessed on a regular basis.

From a fiduciary perspective, plan trustees are charged with the task of protecting investment assets. But in this difficult financial environment, the task is further complicated. The Dow Jones Industrial Average took an historic dip well below the 10,000 mark in 2008, losing significant market value over the course of the year. Even healthy and well-funded plans run the risk of being underfunded due to the significant market downturn. Labor plan trustees find themselves under a tremendous amount of stress. The job of the auditor also becomes much more complex, as CPAs perform financial statement audits and deal directly with anxious clients concerned about their financial condition.

Auditors understand and recognize the challenges facing plan trustees. This is often a time when impulsive decision-making can be the undoing of a plan fiduciary or investment manager. Auditors are often the last to know about a client's swift and possibly unwise moves as far as plan management and investment decisions. Typically, CPAs perform financial audits, which are reviews on the prior year. As

Even healthy and well-funded plans run the risk of being underfunded due to the significant market downturn.

1 The Wall Street Journal Online, "Madoff's Victims," 6 March 2009, http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html (5 February 2009)

part of the audit, the CPA assesses the risk of the organization as it relates to the type of investments held and transactions completed. But the skilled and experienced auditor can also advise as to risk mitigation strategies.

As trustees oversee labor union plans and follow the activities of outside investment advisors, consultation with an auditor offers needed insight into best practices and control methods to safeguard these assets. It is clear that the Employee Retirement Income Security Act of 1974 (ERISA) requires plan sponsors and fiduciaries to oversee and properly manage investments, and these individuals are keenly aware of the growing legal responsibility and exposure they face.

And while auditors are not investment experts, the vast amount of experience garnered from servicing a variety of plans allows an auditor to provide valued insights for reviewing and instituting best practices for investment due diligence. **Mitchell & Titus LLP** provides this white paper to offer labor union plan trustees a proactive approach to risk mitigation and control methods related to their organization's investment strategy.

The Framework for Investment Due Diligence

Market fluctuations are not uncommon. However, handling one of the more difficult economic and investment environments in history poses significant challenges for plan fiduciaries. Developing a workable and responsive investment due diligence strategy helps to ensure plan trustees are meeting their fiduciary duty, as well as mitigating any fraud risk. The framework requires a dedicated approach:

- Plan sponsors must develop strong **corporate governance policies** and procedures to meet their fiduciary responsibilities.
- Best practices should address the **financial reporting internal controls** put in place in order to avoid fraud and other legal problems.
- **Regulatory compliance** is a major part of the trustee's duties. Plan trustees, fiduciaries and outside investment advisors need to comply with the mandated laws and rules under ERISA.

Corporate governance policies take into account the plan sponsor level and the investment trustee or advisor at a service organization. Investments must be safeguarded, and more importantly, investment transactions need to be recorded accurately. The plan trustees also need to review the investment manager's qualifications and experience, as well as his or her compliance with control procedures and investment transaction documentation.

As a part of the CPA audit, we ask questions related to the amount of risk that

...the vast amount of experience garnered from servicing a variety of plans allows an auditor to provide valued insights...

lies within the organization, including the risk created by the types of investments held and transactions completed. The process should consider the possibilities for fraud and errors in reporting. Material fraud, errors or other irregularities can be significantly curtailed or prevented by applying strong internal controls.

Mitchell & Titus LLP can help to evaluate the **financial reporting internal controls**. The process includes a monitoring of investment performance and an analysis of the reports received from investment advisors. It is not sufficient to merely obtain the investment report and acknowledge returns or losses. The plan trustee must have policies and procedures in place to scrutinize and ensure the accuracy of these reports.

The Statement on Auditing Standards (SAS) No. 70 is an essential reporting mechanism. This reporting tool requires an outside service provider with an impact on the organization's financial statement, such as an independent firm overseeing labor union plan investments, to provide the plan's auditor with details on its internal controls, risk management and regular reporting efforts. Auditors can then ask the important questions to understand if there are additional controls necessary to prevent fraud by third party administrators directing plan investments. Plan trustees should push service providers to complete the SAS 70 Type II audit report summary, as it provides test work on the controls in place, making it a much more complete and thorough review of the investment process.

Additionally, plan fiduciaries, trustees, as well as outside investment advisors, must be in compliance with the rules and laws required under ERISA. Proper due diligence necessitates that **regulatory compliance** is a major consideration for the plan sponsors and any individuals entrusted to make decisions for the plan.

The Keys to Investment Oversight

While it might seem to be common sense, plan oversight is the key to investment due diligence. The plan's board of directors, trustees or even an oversight committee should include individuals with relevant and significant qualifications. Their educational background and financial expertise indicates their qualifications for their fiduciary role. The plan trustees and investment managers also need a strong knowledge of Sarbanes-Oxley and ERISA requirements.

Before the plan trustees can mitigate any risk, they must first understand the control environment. The **control environment** and **risk mitigation strategies** are the two key elements to consider. Internal controls are established to monitor and direct plan trustees, fiduciaries and outside investment advisors. Information and communication systems are established to reinforce the controls put in place. Risk mitigation efforts are designed to test the system and determine what could go wrong.

The plan's board of directors, trustees or even an oversight committee should include individuals with relevant and significant qualifications.

An outside auditor can help to test the systems in place and improve the risk mitigation process. Asset and investment protection is essential. Control activities must include whistle-blowing mechanisms in case of fraud, as well as other monitoring efforts. The CPA audit does include an assessment of client fraud risk factors under Audit Standard SAS No. 99, but plan trustees must not overlook their duty to institute policies and procedures to best mitigate any risk to plan investments.

Assessment of Risk in Hard-to-Value Investments

Today, plan trustees deal with the additional risk of hard-to-value investments. These investments might include limited partnerships, derivatives, private equity or hedge fund involvement, and real estate holdings. The complexity of these assets requires considerable financial experience to understand the value of the alternative investment.

When there is some subjectivity to the valuation of an investment, the financial risk can increase for the plan. Unlike more traditional assets or investments with a readily determinable market value, hard-to-value or alternative investments are a major concern for plan trustees and should not compose a major part of the plan's investment portfolio. Financial reporting of these investments demands a rigorous and up-to-the-minute valuation of alternative investments, or the plan may find itself subject to financial restatements or even rejection of the Form 5500 by the Department of Labor.

Investment advisors and bank trustees can assist with the valuation of these alternative or hard-to-value investments, but the assumptions with respect to valuations are the responsibility of the plan. As such, plan fiduciaries must carefully assess and monitor these more risky investments, by:

- Establishing clear valuation policies and procedures
- Evaluating the risk in the investment portfolio based on the mix of more traditional assets with readily determinable market values vs. hard-to-value investments
- Understanding how the investment valuations are calculated
- Reviewing the monitoring policies of bank trustees and outside investment advisors over investment reporting
- Setting up policies and procedures to avoid investments that are beyond the understanding of the plan fiduciaries and investment managers
- Selecting investment managers and other vendors who understand and follow the objectives of your organization

...hard-to-value or alternative investments are a major concern for plan trustees and should not compose a major part of the plan's investment portfolio.

Trustees must also be aware of the regulatory risk with respect to plan diversification. Under ERISA, the diversification requirements are designed to prevent investment fraud and/or a major financial loss attributed to the downturn in a concentrated investment. Plan fiduciaries should employ a qualified ERISA attorney to verify compliance with the law.

Conclusion

As **Mitchell & Titus LLP** continues to work with plan trustees, it is clear that fiduciaries face heightened responsibilities. Labor union plan trustees need to institute the proper controls and follow up on risk mitigation related to their investment advisors. In addition, a tone of integrity must flow throughout the entire organization. Rigorous financial reporting requirements, regulatory compliance methods, and risk/fraud mitigation demand a proactive and evolving control response.

But strong investment policies and strategies are useless unless trustees and investment managers follow these efforts consistently. Additionally, the control process must be documented and reviewed on a regular basis. Plan trustees need to assess the financial stability and experience of investment management service providers.

More importantly, fiduciaries must continue to scrutinize the policies in place. Are plan trustees, fiduciaries and investment managers following established policies and procedures regarding investments? Is there a strong reporting process in place? Are investment transactions well documented? Is the control strategy a responsive one? Plan fiduciaries must ask these critical questions to mitigate risk, prevent fraud, and ensure regulatory compliance and the health of the plan's investments.

After the discovery of the Ponzi Scheme orchestrated by Bernard Madoff, the focus on investment fraud has increased. Plan trustees should regularly monitor investment reports and be aware of any red flags, including investment returns that are unusually consistent and/or out of step with the overall market. Plan trustees cannot be lulled into a sense of complacency simply because investment returns are significant. Returns should be reasonable, and the reporting of the transactions needs to be accurate. Fiduciaries should regularly review the governance structure and seek to alter any deficient controls. The labor union plan should also look to the experienced auditor as a critical and useful partner in their investment due diligence strategy. ■

The labor union plan should also look to the experienced auditor as a critical and useful partner...

White Paper Contributors

Darrell K.B. Giles is a partner in the Philadelphia office of **Mitchell & Titus LLP**, a member firm of Ernst & Young Global Limited. He has over 20 years of public accounting experience as an auditor and tax professional, including over five years with a former “Big Five” CPA firm. He is one of the lead partners for the firm’s Commercial, Not-for-Profit, and Employee Benefit Plan Practices. He is also the chairman of the firm’s National Training Committee and is a certified public accountant in various states.

Irene R. Davis is an audit partner in the Philadelphia office of **Mitchell & Titus LLP**, a member firm of Ernst & Young Global Limited. She is the partner-in-charge of the firm’s Employee Benefit Plan Practice. She is also a member of the firm’s Executive and Quality Control Committees. **Irene** has over 15 years of experience in public accounting and is a certified public accountant in various states.

About Mitchell & Titus LLP

Mitchell & Titus LLP is a regional firm that has provided assurance, tax, transaction support, and advisory services for over 35 years. Notably, it is the largest minority-controlled accounting firm in the United States. With 16 partners and a staff of more than 175, the firm provides services to *Fortune 1000* companies, entrepreneurial enterprises, nonprofit organizations, financial services firms, government entities, and high net-worth individuals. The firm has offices in New York, Rutherford (NJ), Philadelphia, Baltimore, Washington, D.C., and Chicago.

In 2006, **Mitchell & Titus LLP** became a member firm of Ernst & Young Global Limited. **Mitchell & Titus LLP** has the distinction of being one of the few member firms of Ernst & Young Global to maintain its ownership and brand name. However, as a member firm of Ernst & Young Global, **Mitchell & Titus LLP** follows its quality, risk management and independence procedures, as well as has access to leading technological resources and the collective knowledge base of other member firms around the world. In essence, Mitchell & Titus clients experience the best of both worlds—a regional firm with global connections.

The firm’s growth and success is directly linked to its commitment to excellence and professional development. **Mitchell & Titus LLP** is a registered member of the American Institute of Certified Public Accountants (AICPA) and a member of its Center for Public Company Audit Firms. In addition, the firm is registered with the Public Company Accounting Oversight Board (PCAOB) and licensed with various state boards of accountancy.

Additional information about our services and office locations can be obtained at www.mitchelltitus.com.

