

Risk and Reality: Unclaimed Property Audits in Accounts Receivable



The
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Executive Summary

- ◆ Generally, the stated purpose of state unclaimed property laws is to protect the rights of owners or their heirs and provide a single point of contact for an owner to find property.
- ◆ Under the federal Sarbanes Oxley Act of 2002, publicly traded companies are required to attest that certain internal controls are in place and disclosures are made relative to their company's financial statements and financial position. Unremitted and unreported unclaimed property could be considered a risk with a material impact to financial statements. Cash balances may be overstated and liabilities may be understated if unclaimed property is not properly accounted for.
- ◆ By performing due diligence, relationships with key customers and vendors are maintained and a company's credibility is enhanced.
- ◆ State unclaimed property programs are becoming increasingly more sophisticated in detection of noncompliance and "under-compliance". Many states perform research using state tax and incorporation records to determine if a company that is paying taxes or is incorporated or registered in their state also has complied with state unclaimed property laws.

In recent months, Artie's accounts receivable department has been a model. Artie has created a department that has better statistics than the benchmarks; his metrics are amazing. Today, Artie received an email from the company's CFO with an attachment that is an audit notice from a state. The state, or their contractor, is notifying Artie's company that it is auditing the company to determine its compliance with state unclaimed property laws. Artie wonders why the CFO has sent this email to him as manager of the accounts receivable department.....isn't unclaimed property something that just accounts payable deals with?

So, Artie wanders through his day of meetings, emails and telephone calls until he gets another email from the CFO which requires his attendance at a meeting tomorrow to discuss his department's unclaimed property liability and practices. He is asked to email to the CFO a list of aged credits over the past 10 years. Now, does Artie panic or is he prepared?

THE REALITY CHECK

Artie calls an industry colleague that he met at a **Credit Research Foundation** function, who had mentioned unclaimed property in the past. She tells him that her company has undergone an unclaimed audit. Due to confidentiality restrictions, she can't give Artie specifics of her company's particular audit but emails to Artie an article that was in the newspaper in 2006. The article recounts an audit performed by state auditors of a national company where the audit uncovered over \$300,000 in accounts receivable-related unclaimed property. Further, Artie's colleague tells him that unclaimed property audits are becoming prevalent and that accounts receivable is being targeted by state and third party auditors. The colleague notes that unclaimed property has become a significant revenue source for states and that for one of the smallest states, it is the 3rd largest source of revenue! She also says that the scope of some state audits goes back as far as 25 years.

Artie's colleague further explains that accounts receivable departments have a potential unclaimed property issue when any of the following happens and a specific period of time (dormancy period) has passed:

- **A credit is issued for returned merchandise and is unused**
- **A credit is issued in return for an overpayment or duplicate payment and is unused**
- **A volume credit is issued and unused**
- **A payment is received for which no receivable can be identified (unapplied cash)**
- **A rebate is issued and unused**
- **An accommodation credit is issued and unused**

Artie learns from his colleague that a dormancy period is a specific period of time from when the credit is issued until the pertinent state considers the credit abandoned and subject to its due diligence and reporting requirements. For most states that time period is 3 years or 5 years from the credit issue date.

PREPARING FOR AN AUDIT

When Artie's company has its post –audit notice meeting, all of the departments that are likely to have unclaimed property should be represented, i.e., accounts receivable, accounts payable, payroll (uncashed wage and flexible spending account checks, etc.). Also, corporate legal counsel should be present. This “team” should consider the company's game plan for audit preparation, audit matriculation and post-audit. In some instances, hiring outside unclaimed

property experts to assist the team may be prudent in order to effectively manage the audit, avoid unforeseen costs, and defend the company.

1. INTERNAL REVIEW

The first step in preparing for the audit is for departments, like those mentioned above, to perform an internal review to assess how much potential unclaimed property liability the company holds or has written off into income in the past. If records are not available or would be too time consuming or costly to retrieve and review, it may be necessary to devise a statistically defensible sample and employ the appropriate estimation techniques to approximate the liability. If the team is working with outside experts, determining the potential exposure/liability may be expedited.

Once the review is complete, the “team” should consider if the exposure can be minimized or mitigated by performing research or outreach that may resolve items. This is where using outside experts may prove cost effective as they generally can identify opportunities and provide guidance in applying any pertinent exemptions, effective outreach measures, etc., and in drawing independent, sound samples and statistics as necessary. If items are resolved, maintaining appropriate documentation will be important if auditors question the reversals.

2. PRE-AUDIT CONSIDERATIONS

There are some questions/considerations that Artie’s company should consider prior to the audit commencing. First, what is the scope of the audit? In other words, how many years of records will the auditors review to determine compliance. Generally, states “look back” at least 10 to 15 years in an audit but some go as far back as 25 years or more as noted by Artie’s colleague.

Next, who is performing the audit? Are the auditors state employees or are they employees of a third party audit firm contracted by a state or states? Do the auditors represent just one state or a group of states? If so, have the auditors provided the company with proof of authorization to perform the audit on behalf of each of the states?

Finally, the company should consider whether or not to request that the auditors sign a confidentiality agreement. Many businesses have confidentiality policies and may want to protect their processes and client information, etc.

ACCOUNTS RECEIVABLE AND AUDITS

Audits conducted by state and third party auditors in the past provide a glimpse of what may be expected in future audits. The types of accounts receivable records generally reviewed in an audit are:

- Annual general ledger trial balance reports
- Annual accounts receivable aging reports
- Miscellaneous expense account activity Miscellaneous income account activity
- Bad debt write-off account activity

In reviewing these records, states are looking for balances resulting from overpayments, customer adjustments, duplicate payments, bad debit recovery/collection, pre-payments, and deposits, etc.

Recent audits indicate that when a business does not maintain the name and address of the entity owed the aged credit and/or does not retain details regarding the transaction, penalty and

interest assessments are markedly higher. Due to federal court decision, when there is no address information unclaimed property must be reported and remitted to the state of incorporation of the business that holds it. Therefore, in an audit when there is no address information, the state of incorporation of the business, may perform sampling and estimation techniques when aged credit information is missing. Further, when transaction detail is missing, businesses under audit may not be able prove that the outstanding credits are the result of accounting error, therefore potentially creating an unforeseen unclaimed property liability.

RECOMMENDED PROCEDURES FOR REDUCING FUTURE LIABILITY

In order to minimize potentially escheatable accounts receivable credits and unapplied cash, credit professionals should incorporate procedures to address aged credits that are designed to minimize potentially escheatable property, document the treatment of aged credits, and timely escheat any credits which could not be resolved. By implementing the appropriate procedures and retaining pertinent documentation, an accounts receivable manager can be compliant with state unclaimed property laws, escheat less property and be prepared in the event of an unclaimed property audit.

a. Accounting Error Research

The first step in minimizing escheatable credits is to determine if the credit is an accounting error or whether the credit can be offset. For this reason, a listing of aged credits should be reviewed periodically (i.e., every 60, 90 or 180 days). All credits on the list that are over a specific dollar amount (i.e., \$20, \$100, or \$500, etc.) should be researched to determine if they are the result of an accounting error. Examples of accounting errors are:

- Duplicate credits issued
- Credits issued to a customer in error
- Credits applied to previous invoices
- Credits used but not reflected in accounts receivable

If it is discovered that a credit was issued as a result of an accounting error, the credit can be reversed in the businesses' records. Documentation substantiating the reversal should be kept as evidence to present to state or third party auditors if and when they question the reversals. Generally, state auditors are more likely to challenge a reversal, therefore it is imperative that an accounts receivable credit manager maintain this relevant documentation to avoid the credit being included in an audit assessment.

b. Offset

If the credit is not the result of an accounting error and is indeed a valid credit, then the customer's account should be reviewed to determine if there is an offset that can be made against an open or outstanding invoice. Some businesses have provisions in their customer service agreements whereby the customer agrees that any credits aged beyond a specific time period will be offset against any open, outstanding or future invoice. For example, during a presentation at a Credit Research Foundation Forum, credit professional Brad Komarek noted that his former company's policy was to net credits aged 6 months or older against any open debits that are 6 months old or older. Further, consider that in an attempt to resolve unused credits, many businesses, as a practice, add cash application credits and credit memos to

monthly customer statements. Brad noted in his presentation that this also was a practice used by his former employer.

c. Other Resolution Techniques

If credits cannot be resolved through error research or offset, some companies take additional steps to resolve them. It is not uncommon for a business to issue a check in the amount of the credit to the entity owed the credit, after a specific time period has passed and if the credit is over a set dollar amount. While this procedure may not be appropriate for past due property currently under audit, it is a practice that businesses may consider as a method for resolving credits and preventing property from becoming escheatable during periods when they are not under audit. (Note, however, that if the check issued is not cashed, that the business must use the date of issue of the credit (not the check issue date) when determining if the pertinent state dormancy period has run.)

Brad Komarek indicated that his former company's procedure dictated that for any credit over \$20 that remained unresolved after research and due to no valid offset, the company issued a check to the entity owed the credit. (Komarek stated that credits valued under \$20 were moved to the appropriate unclaimed property liability account awaiting the expiration of the pertinent state dormancy period and then due diligence and potential escheatment.)

Brad further noted that if the check is not cashed within 6 months, the check is voided and a follow up due diligence letter is sent to the customer. According to the procedures at Komarek's former company, if the customer responds within 60 days, another check is issued and if no response is received the credit amount is moved to the appropriate state's unclaimed property liability account in his former company's records. Brad stated that his former company then sends out another due diligence letter during the time frames required by state unclaimed property laws and if there is no response to the letter, the funds are forwarded to the appropriate state in the manner specified in state laws.

Another resolution technique is to resolve large customer credits which can't be verified by the customer. Settling the credit through discussion and/or negotiation with the customer can be a means to preventing the credit from becoming unclaimed property and for enhancing the customer relationship. Any credits so resolved with the client should be documented along with proof of customer agreement to the settlement.

d. Exempted Items

There are state unclaimed property laws which exempt credit memos and balances from being considered as escheatable or reportable unclaimed property. For example, Kansas unclaimed property law exempts, "any outstanding check, draft, credit balance, customer's overpayment or unidentified remittance issued to a sole proprietorship or business association as part of a commercial transaction in the ordinary course of a holder's business".¹ Another example is Massachusetts' abandoned property law which exempts, "any outstanding credit balances to a vendor or commercial customer from a vendor resulting from a transaction occurring in the normal and ordinary course of business".² Similar to these "business to business" exemptions some states have a "de minimus" exemption. Florida unclaimed property law has such a

¹ Kansas Annotated Statutes, Chapter 58, Article 39, Section 3935, Para. 17 (g)

² The General Laws of the State of Massachusetts, Chapter 200A, Section 5.

provision which exempts, “Credit balances, customer overpayments, security deposits, and refunds having a value of less than \$10...”³

Unfortunately, no two state exemptions are exactly alike and it can be difficult to determine if an exemption applies. For the exemption to apply to a particular item, specific criteria must be met as set forth in state statute and regulation. For example, note that Massachusetts regulation defines “commercial customer” for the purposes of the business to business exemption mentioned above. The definition in the regulation is:

“Any person who maintains a current, multiple transaction, commercial relationship with a vendor in the conduct of the person’s business within Massachusetts or through a vendor conducting business in Massachusetts. No individual purchasing goods or services in his/her capacity as a consumer at retail shall be considered a commercial customer.”⁴

Further, Massachusetts regulation defines “credit balance” as:

“Outstanding balances that are recorded as current accounts receivable or accounts payable of a holder. The balance must have been generated in the normal and ordinary course of business between the holder and a then current commercial customer”⁵.

Also, note that some of the exemptions apply from a specific date forward and do not apply to items that were issued prior to that date.

If an exemption validly applies to an item it should not be considered past due in the event of an unclaimed property audit. Auditors, however, may request documentation that proves that the exemption applies. For this reason, it is important that the accounts receivable manager, in minimizing escheatable unclaimed property, maintain substantiation information of any items exempted from unclaimed property reporting.

ARTIE’S REPRISE

Artie’s dilemma when notified of an unclaimed property audit is shared by accounts receivable managers throughout the United States. Credit managers can prevent significant exposure in an unclaimed property audit by being proactive. Establishing and following written policies and procedures designed to minimize exposure through research and aged credit resolution are key to avoiding liability. A part of those procedures should include retention of documentation to substantiate items which were reversed due to accounting errors, offset or exemption application. Artie’s accounts receivable department could have been a “model” for escheatment compliance and liability avoidance if he had been proactive! Unfortunately, his department’s amazing metrics maybe overshadowed by any unclaimed property liability identified in the upcoming unclaimed property audit.

This information was created by Abandoned Property Services, LLC (APS) for reference only, and is not intended to be legal advice. APS does not provide legal services and encourages readers to consult with their legal advisors. The data herein is current as of the date posted.

³ Florida Statutes, Chapter 717, Paragraph 117 (1)(h)

⁴ 960 Code of Massachusetts Regulations 4.02

⁵ Ibid.

Author Bios:

Carla McGlynn, APS LLC's Director, supervises and coordinates APS' consulting and annual compliance services. Prior to joining APS, Carla was the Metro New York Area Director of Unclaimed Funds Advisory Services for Ernst & Young LLP. In addition, McGlynn formerly served as the Tri-State Area Leader for Deloitte & Touche LLP. Ms. McGlynn holds a Masters degree in Taxation from Fairleigh Dickinson University, and a Business Administration/Accounting undergraduate degree from Montclair State University. Carla is involved in several committees of the Unclaimed Property Professionals Organization (UPPO) including the Education, Speakers, Marketing, and Holders Exchange Committees. McGlynn has provided escheatment education at industry events such as those hosted by UPPO, Lorman, the National Association of Credit Management (NACM) and the Tax Executives Institute (TEI).

Carla's extensive unclaimed property consulting experience includes identification and quantification of a company's unclaimed property exposure, mitigation and coordination of evidence to support the appropriate escheat treatment of the unclaimed liability, voluntary disclosure representation and negotiate with all states' administrators and agents, audit defense and management (including third party agent audit defense), development, enhancement and implementation of unclaimed property reporting policies and procedures, compliance process automation, training sessions, and annual reporting compliance.

Karen Anderson, APS LLC's Senior Compliance Advisor, is a 20-year veteran of the unclaimed property industry who guides businesses in achieving compliance. Formerly, Anderson served as Illinois' unclaimed property administrator and later, National Association of Unclaimed Property Administrators' Director. Karen now serves on the Unclaimed Property Professionals Organization Board and holds a law degree from Chicago's Loyola University.

Anderson is a frequent speaker / escheatment educator at trade association events and webinars such as the Credit Research Foundation Forum, the Federation of Credit and Financial Professionals webinars, the International Accounts Payable Professionals Conference, The Accounts Payable Network Conference and audio conferences, the Association for Financial Professionals and the Institute for Management Administration, etc. Karen has authored numerous unclaimed property articles and publications including "The Credit Professional's Guide to Unclaimed Property" published by the Credit Research Foundation.

About Abandoned Property Services, LLC (APS): APS offers affordable unclaimed property expertise designed to achieve and maintain an organization's compliance and minimize its future risk. With over 120 years of combined experience APS staff provides audit defense and liability prevention services as well as compliance maintenance via APS' annual reporting and due diligence services. Further, APS offers procedures development and policy manual creation services plus on-site compliance training.

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