



The Inevitability of Escheatment Audits: Minimizing Your AP Exposure

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Accounts payable professionals are increasingly being asked to implement new procedures and safeguards for ensuring that accounting standards, privacy regulations, and/or company policies are followed. The threat of internal or external audit and possible sanctions looms for those who are not vigilant and diligent. Compliance with state escheatment laws requires one more set of procedures that the accounts payable professionals must devise and follow to prevent or at least minimize liability for noncompliance.

Consider the following scenario:

Joan Practitioner, a seasoned and certified accounts payable professional, is sitting at her desk at Medeum Co. when she receives an email from the legal department. The email states that the company has received an audit notice from a firm called Markel indicating that Markel, a third-party audit firm, represents 20 states that want to audit Medeum Co.'s compliance with state unclaimed property laws. The legal department indicates that they are scheduling a meeting in which Joan along with colleagues from several other departments (accounts receivable, payroll, general accounting, etc.) are required to attend. Joan immediately wonders why Medeum Co. was selected for audit and what may be the accounts payable department's responsibilities and liability.

For some this is a familiar scenario and for others it's an eventuality. Reality is that states are becoming more and more aggressive in auditing businesses for unclaimed property. As the states seek more revenue in tough economic times, more businesses will be audited for unclaimed property compliance. Further, state auditors and the third-party auditors hired by states are becoming creative in the types of items they consider unclaimed property and in the extrapolation techniques they use when records are unavailable. For the accounts payable practitioner the best protection is to take the offensive and effectively manage potentially escheatable items.

Escheatment Management

While no two state escheatment laws are exactly the same, most have four basic obligations that are required of businesses:

1. Record Review/Procedural Due Diligence
2. Statutory Due Diligence
3. Reporting and Remitting
4. Record Retention / Funds Preservation

Having the appropriate procedures to minimize escheatment can serve to fulfill the first obligation. Further, it can decrease the number of items for which due diligence must be performed in compliance with the second obligation and which must be reported and remitted to fulfill the third obligation. In other words, establishing and following the appropriate procedures can significantly reduce the time and effort escheatment compliance requires.

Establishing Procedures/Procedural Due Diligence

A list of stale-dated checks should be reviewed within 60 - 120 days from check issuance. Of course, the volume of checks for review must be taken into consideration and a materiality limit set (i.e., all checks over \$500 or \$1000 will be subject to review, etc.). The review procedures should resolve the following three questions with regard to a stale-dated accounts payable check:

1. Is the payee really lost?
2. Is the check/property really unclaimed property?
3. Is the property exempt from reporting?

Lost Payee?

You may think that the payee's address in your records is incorrect as items have been returned from the post office as undeliverable. In some cases, the address can be corrected by reviewing the contract or other internal documentation. Also, it may be possible to find the address of a sister subsidiary or parent company in your business' vendor master file. From that address and contact information, you may be able to retrieve a new address for the payee.

External address sources, both free and paid, are available as well. Note that there are "free" internet address search sites such as, www.anywho.com, www.switchboard.com, and www.peoplefind.com. Some businesses participate in the United States Postal Service's (USPS) address change service, which provides address correction. Also, commercial software and USPS software are available that can assist in retrieving a more recent address. Once a better address is retrieved, the payee should be contacted about the check and, if appropriate, the check reissued.

Unclaimed Property or Accounting Error?

Sometimes items on the stale-dated check list are in reality the result of accounting error. An accounting error is not unclaimed property subject to the statutory due diligence and reporting requirements of state statutes. The review procedure should require that suspect items valued at over the materiality limit be researched to determine whether or not they are accounting errors. Some common errors are:

- Checks re-issued without voiding originals.
- Duplicate payments.
- Checks with the wrong payee listed.
- Inter-company payments (payments between related companies).
- Periodic/recurring vendor payments (utilities, landlords, etc.).
- Reconciliation error (i.e., bank reconciliation includes checks with sequential numbers outstanding/bad check run).
- Checks that represent payments for invoices for which credits were issued.

When the review reveals that an item on the stale-dated check list is an accounting error, the item can be reversed. However, it is important to keep documentation that substantiates the reversal in case of an unclaimed property audit.

Exempt Items

Some state unclaimed property laws include exemptions for specific types of unclaimed property or property valued at less than a particular dollar amount. Some of the exemptions are more easily interpreted and applied. For example, Florida law exempts credit balances, customer overpayments, security deposits and refunds that are valued at less than \$10 while Colorado exempts 2% of the property remitted or \$25, whichever is more or less dependent upon the property type in question. Further, there are 12 states that have some type of business-to-business exemption; however, many of them do not apply to vendor checks. The business-to-business exemptions in Illinois and Ohio laws, for example, do appear to apply to vendor checks but only if they meet specific criteria. Some states have exemptions for items issued by a business in a specific industry.

Taking exemptions can be risky due to the state prescribed specifications for exemption eligibility and the administrative/recordkeeping requirements. For this reason and to minimize the risk that the exemption taken could be overturned in an escheatment audit, it is advisable to seek the advice of legal counsel before applying any exemptions.

If an accounts payable professional determines that an item is exempt, the accounting treatment of that item should be considered. There may be a possibility that the business' state of incorporation may claim the item in an audit or that the exemption taken could be considered to

have been taken in error in an audit. For this reason, it is advisable to make the journal entry to move the item into the Unclaimed Property liability account and to maintain it there in perpetuity or until another determination is made. Note that in some states maintaining a record of an item considered exempt under their business to business exemption is required.

Contact Prior to Required/Statutory Due Diligence

Many businesses make it a practice to send payees a letter or make a telephone call to payees of stale-dated checks. This becomes a part of their review procedures. Some companies call this letter a "research letter" and use it to verify with the payee that the invoice is outstanding and/or to verify the address of the payee in their files. The letter can be tailored so that the payee may respond that there is no longer an outstanding obligation (basically verifying that the item is an accounting error). For audit purposes, it is essential that the payee's response that there is no outstanding obligation be retained to verify any reversal taken.

If a business makes telephone contact with the payee of a stale dated check, it is important that a record of the conversation be kept, particularly if the payee indicates that the check was cashed and/or that the obligation is no longer outstanding. For audit purposes it is important that the communication record indicating that there is no outstanding obligation be kept with sufficient detail to substantiate any reversals taken. This can be satisfied by an email correspondence sent to the payee for confirmation of the conversation and appropriate follow-up.

Written Procedures - Audit Defense

While thorough compliance is the best defense in an unclaimed property audit, showing good faith in attempting to comply is a close second. Having and adhering to comprehensive written procedures, including those for address correction/research and error detection, may indicate to unclaimed property auditors a business' good faith. Third-party auditors, who are normally paid by states a percentage of the unclaimed property they find, may consider written procedures an indicator that a business is substantially in compliance. In this situation, the third-party auditors may spend less time on the audit as they may believe they are unlikely to uncover a substantial amount of unreported, past due unclaimed property.

Conclusion

In summary, efficient escheatment compliance and planning for potential audit defense is a matter of managing potentially escheatable items in a manner that minimizes unclaimed property exposure, provides for proper record retention, and causes timely statutory due diligence and reporting. This article stresses the procedures that can significantly decrease the number of accounts payable items subject to state unclaimed property due diligence and reporting requirements. However, the compliance obligations of statutory due diligence and reporting also must be provided for in procedures to ensure that a business maintains its compliance annually

and limits its audit vulnerability.

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