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Sarbanes-Oxley Act: Using §404 Review Process To Comply With State Unclaimed Property Laws

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INTRODUCTION

The Sarbanes-Oxley Act of 2002 established new federal requirements designed to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the act. One of the key provisions of the act is found in §404, which essentially directs the Securities and Exchange Commission to issue rules requiring that annual reports filed with the SEC clearly state the responsibility of management to establish and maintain adequate internal controls over financial reporting, as well as management's opinion about the effectiveness of these controls.

One potential pitfall in these new reporting requirements is the impact that they might have on the treatment of unclaimed property. In this article, the authors discuss the interface between Sarbanes-Oxley and unclaimed property reporting responsibilities at the state level. Specifically, the article examines why an unclaimed property review under §404 might be needed, delineates how property can be inadvertently omitted from the review process—thereby causing potential material errors in the financial statements—and provides practical suggestions on how to avoid omissions of unclaimed property during the review process.

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By way of background, Sarbanes-Oxley generally applies to issuers of SEC registered securities and certain other SEC registrants as well as to certain professional service providers. Furthermore, some companies that are not otherwise subject to the act have elected to voluntarily comply with its provisions because they view the act as representing "best practices" that improve the accuracy of their financial reporting.

OVERVIEW OF UNCLAIMED PROPERTY

All 50 states as well as the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have enacted unclaimed property legislation. With states facing increasing budgetary concerns, collection of unclaimed property has become an attractive way for states to obtain additional revenues without raising taxes.

When the owners of intangible (and in some cases tangible) personal property fail to claim it after a requisite period of time—referred to by most states as the "abandonment" or "dormancy" period—the property generally reverts to the state. Our increasingly mobile society generates large amounts of unclaimed property. For example, an individual may have switched jobs and failed to cash or receive his or her last paycheck, may have moved to a different city and forgotten about a small bank account balance, or may have failed to re-

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ceive dividends checks and/or shares in a new company created by corporate merger or takeover.

Companies, generally referred to in unclaimed property parlance as ''holders,'' are required to report and remit their unclaimed property each year to the various states in accordance with the priority ''rules of jurisdiction'' established by the U.S. Supreme Court.[1] Upon its receipt of the property, a state is generally required to hold that property in perpetuity on behalf of the owner. But in practice, only a small percentage of unclaimed property is ever claimed; thus, these funds become, in effect, a source of interest-free revenue to states. A holder's failure to report and remit unclaimed property in accordance with applicable state law can result in imposition of interest and penalties.

An unclaimed property analysis can add substantial value to the §404 review process by assisting management in identifying the critical areas where problems can arise and in formulating possible solutions.

In recent years, almost all states have retained third-party contract auditors to conduct unclaimed property audits. Because these auditors often represent numerous states, an audit conducted on behalf of one state may in essence be a multi-jurisdictional audit. These third-party auditors are typically compensated with a percentage (up to 12 percent) of the funds they recover for the states. State budgetary woes, along with the states' use of third-party auditors, may account for recent increased frequency of audits in this area.

As part of their unclaimed property laws, most states have enacted an ''anti-limitation'' provision that bars the application of traditional statutes of limitation. Thus, the unclaimed property audit look-back periods can extend for long periods (*e.g.*, 15–25 years). Some states, for example, take the position that it is permissible to extend an audit back to a company's original date of incorporation. Accordingly, many states routinely use estimation techniques to make large assessments for periods for which records may be wholly or partially incomplete.

These extensive audit look-back periods can be problematic for holders that might not have sufficient records to establish affirmative defenses to assessments for early periods.

IMPORTANCE OF SECTION 404 REVIEW

Under §404, a company must specifically document management's assessment of the effectiveness of the company's internal control structure. However, depending upon the company, as well as the types and amounts of unclaimed property it may have, there could be inadequate processes and procedures in place to identify the risk of a material misstatement on the financial statements.

The term ''materiality'' is used to describe the significance of financial statement information to decision makers, such as shareholders. In one sense, information could be considered material if it is probable that its omission or misstatement would influence or change a decision of the stakeholders, such as investors or lenders. In its ''Statement of Financial Accounting Concepts No. 2,'' the Financial Accounting Standards Board stated that ''the omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or omission of the item.''[2]

Because unclaimed property audits routinely address long audit periods, an amount attributable to a year early in the period (for example, 15 years in the past) might not have been considered material at the time, but could become ''material'' when combined with applicable interest and penalties over the subsequent 14 years. For example, an annual unclaimed property liability of $50,000 for a company that has not reported its unclaimed property could result in an assessment of $750,000 when penalties (imposed in some instances at rates exceeding 20 percent) and compound interest (ranging from 10 percent to 15 percent in the various states) are imposed.[3] Accordingly, addressing unclaimed property during the §404 review may be appropriate to ensure compliance with the act and to avoid potentially misleading financial statements.

Risk areas relating to unclaimed property are not always easy to detect. Myriad issues may arise from a taxpayer's core business (such as how to handle accounts receivable) as well as from the taxpayer's vendor payments. For example, retailers might have substantive issues both with payroll and with unredeemed gift certificates and gift cards. An unclaimed property analysis can add substantial value to the §404 review process by assisting management in identifying the critical areas where problems can arise and in formulating possible solutions. The nature and scope of this type of analysis will necessarily vary depending upon the size of the organization, its unclaimed property compliance history, prior merger and acquisition activities, availability of detailed records, and the complexity of the organization's accounting systems.

The rest of this article focuses on common omissions of unclaimed property, as well as practical suggestions that may be considered in the §404 review process.

HOW UNCLAIMED PROPERTY IS OMITTED

It is not uncommon for unclaimed property to be inadvertently omitted from the §404 review process. Among the common scenarios we encounter are:

[1] *Texas v. New Jersey*, 379 U.S. 674 (1965), established priority rules for reporting and remitting property (*e.g.*, the primary rule holds that the property reverts to the state of the owner's last known address; under the secondary rule, the property reverts to the state of the holder's domicile).

[2] *See* FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, 132 (1980).

[3] *See* Andreoli and Osibodu, ''Unclaimed Property'' *The Journal of Accountancy*, February 2004, for a more detailed discussion of this issue.

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■ failure to implement policies and procedures to identify and track unclaimed property;

■ failure to maintain proper records to refute the presumption of abandonment that a state may assert during an unclaimed property audit review;

■ lack of awareness within management concerning the technical rules supporting unclaimed property laws;

■ failure to perform due diligence during a merger or acquisition to establish whether the target company or seller has complied with unclaimed property laws;

■ reclassification of outstanding obligations to ''income'' without taking into account the application of unclaimed property laws;

■ decentralized accounting systems and operations that may result in pockets of isolated compliance within the organization—such as one business group or division being in compliance while others are not; and

■ failure to address unclaimed property compliance as it relates to third-party administered programs (*e.g.*, outsourcing of stock and dividends, payroll and benefit programs).

Avoiding Omission Of Unclaimed Property

To reduce the likelihood that unclaimed property will be omitted during the §404 review, we recommend that taxpayers consider taking the following steps:

Look at Existing Activities

First, during the review, an assessment of the company's financial records and business activities should be performed to reveal the existing unclaimed property compliance activities of the organization and to identify those areas where unclaimed property issues could arise. Are unclaimed property policies and procedures in place? What is the prior unclaimed property compliance history? Do the organization's general ledger accounts reflect ''unclaimed property liability''? If the organization has geographically decentralized accounting centers, are the different centers knowledgeable regarding their duties as related to unclaimed property laws? How is information from the operating departments (*e.g.*, accounts payable, accounts receivable, payroll, etc.) accumulated for purposes of unclaimed property reporting?

Set Up Knowledge Management System

Second, during the §404 review, knowledge management procedures should be created to ensure that institutional knowledge is shared and retained generally rather than residing solely with a few individuals. Experience indicates that dissemination of unclaimed property knowledge can be achieved by establishing an unclaimed property committee comprised of four to seven individuals from the various operating departments, as well as individuals from the controller, treasury, legal counsel, and internal audit and tax departments. For example, with retailers, someone knowledgeable about gift certificates and gift cards might be an excellent candidate, while in the oil and gas industry someone from the land department or division order group would be a logical candidate for the committee. The committee should meet periodically, keep minutes or records of its actions, and assist with knowledge dissemination.

Review the Appropriateness of Records

Third, the §404 review can assist in determining whether the appropriate records are in place as necessary for unclaimed property documentation purposes. Many states take the position that if a check has been issued and remains outstanding at the end of the dormancy period, then a ''prima facie'' case of abandonment has been made. This position shifts the burden to the company to establish any affirmative defenses (*e.g.*, payment via a reissued check, extinguishment of the underlying debt, etc.).

Unfortunately when they don't have the underlying accounting records, many companies erroneously assume that there is no unclaimed property. State auditors routinely use estimation techniques to make assessments in these situations; a company is usually better off when the records are available. The review process can determine whether appropriate record retention schedules are in place and are being observed. Most states have a 10-year retention policy in the unclaimed property area, which may be different from the corresponding policy for tax or other financial records.

Evaluate Internal Controls

Fourth, the §404 review can assist in determining whether appropriate internal controls are in place to prevent fraud. Financial statement fraud is defined by the American Institute of Certified Public Accountants (AICPA) as ''an intentional act that results in a material misstatement of the financial statements.''[4] Applying this standard, states might view as fraudulent any instances in which management knowingly reclassifies into income large outstanding balances of unclaimed checks or customer overpayments instead of reporting these amounts to the states as unclaimed property.

Sufficient Monitoring Controls

Fifth, the §404 review can assist in detecting whether sufficient monitoring controls are in place. In some situations, it may be appropriate for the company's internal auditors to periodically review certain business units to determine if they are in compliance with unclaimed property laws by reviewing whether the various units are adhering to the company's unclaimed property policies and procedures.

Report Potential Control Weaknesses

Sixth, the §404 review can assist in evaluating whether there are processes in place for employees to report potential control weaknesses relating to unclaimed property transactions appearing on the general ledger and for determining appropriate follow-up actions.

Consider the Impact of Business Reorganizations

Seventh, the §404 review can assess whether there are processes in place for analyzing the implications of significant business changes, such as mergers and ac-

[4] See AICPA (2002) Statement of Auditing Standards (SAS) No. 99, Consideration of Fraud in a Financial Statement Audit.

quisitions. In some situations, companies focus on their core businesses but, surprisingly, have no systems in place to monitor previous unclaimed property compliance of acquired companies.

Identify Training Needs

Eighth, the §404 review process can assist in identifying whether appropriate training initiatives are in place. Given the fact that many states amend their unclaimed property laws each year, it behooves companies to keep abreast of changing rules through a recurring training program. Addressing this need for training, Unclaimed Property Holders Liaison Counsel (a group consisting of various companies) offers training programs to the holder community.

Use Technology Effectively

Ninth, during the §404 review process, consideration should be given to new technology applications as well as to enhancements to existing applications. Many companies, particularly those with decentralized accounting operations, may want to consider the use of an ''intranet site'' to manage their unclaimed property data. The information pertinent to unclaimed property reporting requirements for all 50 states can also be housed in the intranet site for ready access by all groups. Information made available on a site of this nature might include: abandonment periods for various property types, reporting due dates, due diligence requirements to locate missing owners as required by the various states, and aggregate amount reporting requirements for small amounts.

Consider the Practices of Third Parties

Finally, the §404 review process can assist in identifying situations where unclaimed property exposure could result from the actions of third-party agents. Many companies fail to realize that their third-party agents, such as stock and dividend transfer agents, administrators of benefit plans, and providers of payroll services, can trigger unclaimed property liability for the company through their actions or omissions. Holders that use third-party providers to process potential unclaimed property items must keep in mind that outsourcing these functions does not extinguish holder liability.

SUMMARY

Section 404 of the Sarbanes-Oxley Act of 2002 is intended to ensure that appropriate internal controls are in place to facilitate accurate and reliable financial reporting. While general ledger accounts are selected for testing based on their materiality to the overall financial statements, consideration should be given during the §404 review to address any unclaimed property exposure that might result from these accounts. For example, general ledger accounts may generate unclaimed items. Cash accounts may potentially create various types of unclaimed checks. Accounts receivable accounts may create unclaimed credit balances or overpayments, and unearned income accounts (*i.e.*, sales of gift certificates or cards) may create unredeemed balances. Also, miscellaneous income accounts may reflect reclassification of various unclaimed items not reported as required by an applicable state.

Given the complexities of the myriad situations in which unclaimed property can arise, the increased attention in this area by many states and their contract auditors, and the potential adverse financial impact that may result from unclaimed property audits, it is important for companies to conduct unclaimed property reviews as part of their §404 review process.

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