Unclaimed Property

How to comply with the undisclosed liability and reporting requirements.

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Unclaimed property has become increasingly important in the past few years as more states conduct unclaimed property audits of entities that hold such assets. In a period of economic downturn, the states see unclaimed property as a viable nontax revenue source. In this environment CPAs should be aware of state laws as well as some of the financial reporting issues surrounding unclaimed property.

This article will be of particular interest to CFOs, controllers and other CPAs with responsibilities in either the accounting or financial reporting areas because of the potential impact unclaimed property has on a company's financial statements. In addition, in the current regulatory climate there are increasing pitfalls for companies with misleading financial statements. This article is designed to acquaint financial executives with the problems associated with improperly classifying unclaimed property liabilities and offers guidance to CPAs on how to avoid them.

Internet resources

Unclaimed Property Holders Liaison Council. Promotes the rights of unclaimed property holders, www.uphlc.org.

National Association of Unclaimed Property Administrators. Nonprofit organization affiliated with the National Association of State Treasurers. Includes a free link to help reunite owners with their unclaimed property, www.unclaimed.org.

Unclaimedfunds.org. Subscription Web site that offers access to 55 searchable databases to locate unclaimed property, www.unclaimedfunds.org.

The basics

Unclaimed property is generally defined as a liability a company owes to an individual or entity when a debt or obligation remains outstanding after a specified period of time. An uncashed payroll or dividend check is a common type of unclaimed property. The value of the negotiable instrument represents the debtor's obligation to the payee. When the payee does not extinguish the debt by cashing the check, this creates a property right protected by state unclaimed property laws.

Example. At the end of a pay period an employer accrues its payroll costs by recording a debit to payroll expenses and a credit to payroll payable. On payday the employer debits payroll payable, credits the payroll cash account and issues a check to the employee. When the employee presents the check to his or her bank, this extinguishes the debt and relieves the employer of the liability. However, if the employee fails to present the check, the employer's payroll liability remains outstanding. The fact that the check goes uncashed does not remove the employee's property right (as evidenced by the payroll check) nor does it eliminate the employer's obligation to compensate the employee. If the employer voids or writes off the stale payroll check, it understates its liability (wages payable). The uncashed payroll check becomes "unclaimed property" after it has remained outstanding for a period of time (one year or more as specified by state statute).

Businesses or holders of unclaimed property first must exhaust all options to locate the property's rightful owner through a process of due diligence before determining in which state to report the abandoned property. CPAs can help by ensuring the company has policies and procedures in place to track potential unclaimed property amounts and comply with applicable reporting and remittance requirements of the various states.

Here are some policies CPAs can recommend companies implement:

- Control all unclaimed property through separate accounts that are subject to a high level of internal control.

- Require that all transactions in and out of the accounts have supervisor review and approval.

- Capture and retain sufficient data on the name, address and taxpayer identification number of the property owner to enable the company to properly report the unclaimed assets to the state.

- Follow up on outstanding checks and credits after six months (not after two or three years when the trail is cold).

In addition CPAs should remind companies to be attentive to the potential unclaimed property exposure inherent in any business acquisition and emphasize the importance of due diligence efforts before a company completes any significant merger or acquisition.

Missing records and the use of estimates

Given the long-term nature of unclaimed property, CPAs continually encounter problems with the availability of company records or the lack of certain types of records. Because of inadequate record-retention policies, most unclaimed property holders do not maintain their records intact beyond six or seven years. In many cases companies discard supporting detail for general ledger entries, such as journal vouchers, journal sheets and the like after three to seven years.

When investigating a company, a state unclaimed property examiner frequently faces a similar lack of supporting detail and may be forced to estimate the company's liability—potential to its disadvantage. State examiners have used estimation techniques for decades. Several areas of auditing use these techniques as well—for example, when an entity loses records due to fire, flood or other natural disaster. Sales and use tax auditors also regularly employ estimates to produce audit findings.

Section 30(e) of the 1981 Uniform Unclaimed Property Act specifically permits the use of estimates where sufficient records are not available to identify unclaimed property amounts. When performing routine tests, an unclaimed property examiner may discover the holder has written off or otherwise removed certain items from its books. Companies seeking to anticipate their potential liability from a state audit will find examiners use a variety of estimation techniques depending on the factual circumstances he or she encounters. This includes standard statistical and mathematical tools and models such as regression analysis, ratio analysis and curve-fitting techniques.

CPAs can recommend a company take several proactive steps to avoid having state auditors estimate its unclaimed property liability.

- All entities should adopt polices and procedures relating to how long they keep certain records, keeping in mind there is no statute of limitations on unclaimed property.

- Each organization should recognize that state unclaimed property laws typically require retention periods longer than tax statutes, with 10 years being an average.

- An entity should undertake a periodic review to ensure it observes proper unclaimed property procedures and identifies and reports potential unclaimed property at the right time to the proper jurisdiction.

Estimating a potential liability

Companies often mistakenly believe the lack of historical books and records translates to no unclaimed property liability and that state unclaimed property auditors will be unable to issue an assessment. As noted above, when books and records are not available to determine a holder's actual unclaimed property liability, auditors can estimate it. But CPAs should emphasize to their employers and clients that estimation techniques are not a substitute for recognizing an actual liability.

CPAs should use these techniques to determine a company's liability only as a last resort.

Unclaimed property holders have unsuccessfully argued that states should not use estimation and statistical sampling to project liabilities. The courts have held properly grounded statistical sampling and estimation techniques to be a reliable way of determining unclaimed property liability when records are not available (as in State of New Jersey v. Chubb).

When its historical books and records are missing, a company can estimate its unclaimed property liability using a formula: P x X % = U. In this formula P represents the population of accounting transactions, X represents the unclaimed factor expressed as a percentage and U represents the unclaimed property liability based on the assumption that in a specified population of accounting transactions a certain percentage will end up being unclaimed. The percentage varies based on property type, unclaimed amount, industry, size of company, internal control structure and other relevant variables.

To estimate a client or employer's liability, CPAs first must establish the population of accounting transactions. This may be the company's annual expenses, outstanding checks during a given period of time or accounts-receivable credits at a particular point in time. Frequently, a CPA's judgment is critical in determining the "population technique" used in a given situation. The CPA's next step is to determine the unclaimed factor by analyzing a sample to find the frequency of unclaimed items. Then he or she can plug these numbers into the equation to compute the liability.

Where companies report unclaimed property. For nearly half a century, states have tussled with the complex issue of which has the superior right to escheat—or hold as a custodian for the owner—unclaimed or abandoned property. In the seminal case Texas v. New Jersey, the U.S. Supreme Court held that using the state of the creditor's last known address was a simple and factual way to address the problem. For "ease" in administering the law, the Court decided to use the state of the owner's last known address (as evidenced by the holder's books and records) as the state with the superior claim. According to the Court, however, if this state is not identified or does not have an unclaimed property law, the state of the debtor's incorporation may claim the property.

Noncompliance with unclaimed property laws

Failure to comply with state unclaimed property laws can prove to be costly to a holder. For example, an entity that fails to file annual unclaimed property reports significantly increases the likelihood of an audit. States and their agents routinely audit companies that do not file annual unclaimed property reports or those that consistently file negative reports certifying they have no unclaimed property. The administrative and economic stake is much higher once the state issues an audit assessment; under the rules of most states, a holder then has the burden of refuting the presumption of abandonment and proving the assessment is incorrect.

States also can statutorily assess interest and penalties, the cumulative effect of which could be material to a company's financial reporting. For example, assume a holder's annual unclaimed property audit liability is $50,000. Based on the average reach-back (or look-back) period of 15 years for holders that never have filed unclaimed property reports, the assessment increases to $750,000. In addition, the state can levy a failure-to-file penalty of up to 25% of the assessment, which in our example is $187,500. In most instances the state also can impose compound interest, ranging from 10% to 15% of the assessment. Depending on the number of years under audit, the initial unclaimed property audit liability could double after penalties and interest. In addition to the civil sanctions various states' unclaimed property laws impose, some states also file criminal charges against companies that fail to comply with reporting requirements.

Based on the hypothetical illustration above, the cost of not complying with state unclaimed property laws could be significant enough to have an adverse effect on the company's financial statements. This would

require it to make a full disclosure and force it to restate earnings for prior years.

Recognition and disclosure issues

In many instances companies do not recognize and disclose their unclaimed property liability on their financial statements as GAAP requires. The remainder of this article discusses issues related to recognizing and disclosing unclaimed property liability under FASB Statement no. 5, Accounting for Contingencies. It defines a "contingency" in part as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (a 'gain contingency') or loss (a 'loss contingency') to an enterprise that will ultimately be resolved when one or more events occur or fail to occur."

Statement no. 5 says the accounting treatment for a loss contingency depends on whether the likelihood of the future event giving rise to a loss, impairment or liability is

> *Probable*. A future event or events that are likely to occur.
>
> *Reasonably possible*. A future event or events the probability of which is more than remote but less than likely.
>
> *Remote*. A future event or events with only a slight chance of occurring.

According to Statement no. 5, an entity should accrue a loss contingency by a charge to income if it satisfies both of these criteria:

- Prior to the issuance of the financial statements, the available information indicates it is probable the entity has incurred a liability at the financial statement date.
- The amount of the loss can be reasonably estimated.

To prevent the financial statements from being misleading, Statement no. 5 says it may be necessary for the entity to disclose the loss contingency even if it has not satisfied both of these accrual criteria. The statement also says the entity should disclose a loss contingency where there is a reasonable possibility it may have incurred a loss or liability. In the latter situation, the disclosure must include the nature of the contingency and an estimate of the possible loss or range of loss or state that the company cannot make such an estimate. Statement no. 5 doesn't require disclosure of a loss contingency involving an unasserted claim or assessment unless the entity considers it probable the claim will be asserted and there is a reasonable possibility the outcome will be unfavorable.

The issue of quantifying the liability is typically raised when a state notifies a company of its selection for an audit. The company can determine how much it needs to disclose through either a self-assessment process or an audit by an outside party.

The potential undisclosed liability

In general a loss contingency could result when the holder of unclaimed property determines a potential liability. For example, in some situations a holder may need to estimate the unclaimed property liability; in others, the liability may be readily apparent without resorting to estimation techniques. Companies have sought to reclassify these obligations as "miscellaneous income" or make some other financial statement adjustment. This accounting practice conflicts with state unclaimed property laws, which are designed to preserve the property rights of the "lost" owner and prevent unjust enrichment of the company or holders of unclaimed property.

From the perspective of Statement no. 5, companies should answer these questions:

- Is the existence or enforcement of unclaimed property laws probable in their state of incorporation or in the state of their customer's (vendor's, shareholder's, bondholder's, employee's) last known address?
- Can the company quantify or estimate those liabilities outstanding for more than three to five years?

If the answer is "yes" to one or both questions, a company is obligated to reflect an unclaimed property liability on its financial statements and provide additional disclosures in accordance with Statement no. 5.

Example. An employer knows a former employee has not cashed a payroll check. The employer should accrue an unclaimed property liability to reflect the fact some state is likely to seek to recover the unpaid amount as unclaimed property. Applying the standards of Statement no. 5, a company must accrue a loss contingency if information exists the liability is probable at the date of the financial statements and it can reasonably estimate the value of the loss. Because there is an outstanding payroll debt to an employee and states have unclaimed property laws, this satisfies the "probable" element for accrual and the company should accrue the uncashed payroll check and reflect it on its financial statements as an unclaimed property liability.

Customer overpayments (accounts-receivable credit balances) can also be a source of unclaimed property. When customers erroneously overpay, they are entitled to a refund. If the company does not properly classify the liability for the customer overpayment as such, its assets are overstated and its liabilities understated.

Using the standards in Statement no. 5, a holder should evaluate whether it must reflect the outstanding customer overpayment as an unclaimed property liability on its financial statements. The first element for accrual is satisfied because of the probability the company incurred a liability and because the states actively enforce unclaimed property laws. Second, a refund of the overpayment is due to the customer in an amount the company can reasonably estimate (the difference between the original amount due and the amount the customer paid). Therefore, the company should recognize the unclaimed property liability on its financial statements.

The importance of compliance

The increasingly mobile nature of our society and the increased attention states are giving to unclaimed property make it likely this area will continue to grow in importance for CPAs, their clients and employers. It is incumbent upon CPAs, therefore, to help companies proactively develop an action plan to ensure compliance with unclaimed property laws, as well as to give a high priority to it within the organization. CPAs also must help clients or employers assess the financial statement impact of unclaimed property to reduce or eliminate the possibility of significant misstatements.

Practical tips to remember

CPAs can help clients or employers avoid problems with unclaimed property by making sure the company has policies and procedures in place to track such property and comply with applicable state reporting and remittance requirements.

Before a client or employer merges with or acquires a business, CPAs should pay close attention to the potential unclaimed property exposure inherent in any such transaction and make sure due diligence efforts cover this issue.

To avoid having state auditors estimate a company's unclaimed property liability, all entities should adopt polices and procedures concerning how long they keep certain records. State unclaimed property laws generally require retention periods averaging 10 years.
To prevent financial statements from being misleading, a company may need to take the precaution of disclosing a loss contingency for unclaimed property even if the company has not satisfied the accrual criteria in FASB Statement no. 5.

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