

Understanding and Responding to Unclaimed Property Audit Risk

Following the strategies and recommendations outlined in this whitepaper will help businesses mitigate the risks of unclaimed property audits, reduce potential liabilities, and ensure long-term compliance. Companies can protect their reputation and avoid penalties by understanding enforcement trends and adopting a proactive, strategic approach to audits.

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This whitepaper provides an in-depth overview of unclaimed property audits, focusing on the basics of unclaimed property laws, state enforcement trends, and the strategic approaches organizations can adopt to navigate audits successfully. The paper outlines the audit process, from initial audit triggers and the details of audit letters to effective audit defense strategies and finalizing the audit to minimize liability.

UNCLAIMED PROPERTY BASICS: A clear understanding of unclaimed property laws is critical for businesses to ensure compliance and avoid costly penalties. Unclaimed property refers to financial assets that have been abandoned or unclaimed for a specified period, such as dormant bank accounts, uncashed checks, or insurance benefits.

STATE ENFORCEMENT TRENDS: States are increasingly aggressive in their enforcement of unclaimed property laws. Audit activity has intensified, with state authorities taking a more proactive role in identifying non-compliant businesses. Trends show that audits are not only frequent but are also expanding in scope.

AUDIT TRIGGERS AND AUDIT LETTERS: Unclaimed property audits are typically triggered by various factors such as inconsistent reporting or discrepancies between state records and business filings. Audit letters provide crucial details about the audit process, including the time frame, the documents required, and the scope of the audit.

AUDIT DEFENSE TEAM AND COMMUNICATION:

Building an experienced audit defense team is essential. The team should include legal counsel, financial experts, and compliance specialists. Clear communication between the team members and with state auditors can significantly impact the audit's outcome.

AUDIT PHASES: The whitepaper outlines the phases of an audit - from the initial notification and data request to the examination of records and determination of liabilities. Each phase presents unique challenges and opportunities to mitigate risk.

PROPOSED SOLUTIONS AND RECOMMENDATIONS:

AUDIT DEFENSE STRATEGIES: The whitepaper suggests several strategies to defend against unclaimed property audits, including comprehensive record-keeping practices, early identification and resolution of discrepancies, and proactive engagement with state auditors.

LEVERAGING THE AUDIT FOR FUTURE COMPLIANCE:

The audit process provides a valuable opportunity to strengthen future compliance efforts. By reviewing past reporting practices and addressing any gaps identified during the audit, businesses can improve their internal processes and reduce the likelihood of future audits.

UNCLAIMED PROPERTY BASICS

All 50 states, the District of Columbia, Guam, Puerto Rico, the U.S. Virgin Islands, American Samoa, and the Northern Mariana Islands have unclaimed or abandoned property laws. These laws govern how companies, known as holders, in possession of property owned by others, must handle that property when contact with its owners has ceased.

Unclaimed property can be tangible, such as items stored in a safe deposit box at a bank or credit union, or intangible, such as securities, uncashed checks, merchandise credits or other general ledger items. Suppose an owner does not take action or claim his or her property within a specific time, known as the dormancy period, as outlined in the applicable state's unclaimed property law. In that case, the holder must first notify the owner that the property will be reported and remitted to the state as unclaimed property if the owner does not act on his or her account within a certain period of time. If there is no response, for most property types, the holder must report the property in accordance with the priority rules, which dictate that property is reported to the state of the owner's last-known address, per the books and records of the holder, or, if the address is unknown, to the holder's state of incorporation. This process is known as escheatment.

ENFORCEMENT TRENDS

States have expanded their interest in unclaimed property and holder compliance with the unclaimed property laws over the years, resulting in a steady flow of legislation and regulations.

In recent years, many states have updated their statutes based on the Revised Uniform Unclaimed Property Act of 2016. Others have made incremental changes, in some cases, to account for new property types, including virtual currency and online sports wagering accounts.

Delaware has been especially active in revising its unclaimed property statute in response to litigation. More than a million companies are incorporated in Delaware, and unclaimed property will escheat to the state of incorporation if the owner's address is unknown. The state also uses estimation techniques to estimate unclaimed property liability in an audit if a company lacks the adequate records for certain years in question that are covered by the required record retention period. The state has continued to increase enforcement of its unclaimed property law. This has resulted in audits and has led to litigation targeting Delaware's enforcement and audit practices. The state has been forced to implement changes based, in part, on court rulings, making its practices problematic.

States have a lot to gain by enforcing their unclaimed property statutes. Holders who fail to comply may be subject to substantial penalties and interest. For example, Nevada has one of the highest annual unclaimed property interest rates at 18% annually. The state also charges a \$200 per day late filing penalty, capped at \$5,000.

Similarly, California assesses 12% interest on any late-reported property from the date the property was required to be reported until the actual reporting date.

ENFORCEMENT PRACTICES

States are increasingly conducting outreach to ensure holders comply with their unclaimed property requirements. State enforcement can take several forms:

AUDITS

When a state identifies a holder it believes has failed to report unclaimed property correctly, the state may conduct an examination, or audit, of the company's records to establish and collect past-due property plus penalties and interest. States often contract with third-party auditors to conduct such examinations, which frequently last several years and may expand into multi-state audits. The audit process is both laborious and costly for targeted holders.

VOLUNTARY DISCLOSURE AGREEMENTS (VDAs)

Some states offer voluntary disclosure programs, or amnesty programs, that encourage holders to come into compliance voluntarily. California is one of the most recent states to implement such a program. Under a state amnesty program, holders not currently under examination come into compliance, escheating past-due property. States with such programs typically agree to waive penalties and interest for participating companies.

SELF-AUDIT

Several states have begun sending self-audit notices to holders they believe have failed to report unclaimed property. Holders are asked to complete a questionnaire and work with the state's third-party auditor to resolve any areas of non-compliance. Failure to respond may trigger an audit.

VERIFIED REPORTS

Delaware has started mailing letters to holders, asking them to review their most recent unclaimed property report and to certify that it is accurate or requesting that they correct any errors. Holders are also asked to provide copies of their unclaimed property policies and procedures.

COMPLIANCE REVIEWS

Holders who fail to adequately respond to verified report requests or claim they do not have any unclaimed property to report may receive a compliance review request. A shorter review than a full-fledged audit, compliance reviews request documents supporting the most recent unclaimed property report. If the state finds inaccurate reporting, it may collect the amount due and/or refer the holder for a voluntary disclosure program invitation and, if declined, a subsequent audit.

LEGAL ACTIONS

In addition to the previously listed enforcement mechanisms, over the last few years, we have seen an uptick in False Claims Act lawsuits filed by state attorneys general and whistleblowers. If the holder does not prevail, it may be subject to treble damages, which means three times the amount of the underreported property, not to mention the negative publicity that would surround the holder. These actions increase the risk and potential damage companies face related to unclaimed property non-compliance.



AUDIT TRIGGERS

Any number of events may trigger an unclaimed property audit. Mergers and acquisitions can put a company at risk if one or more of the companies involved in the transaction is out of compliance. If a state believes that a holder has underreported or notices significant changes in reporting from one year to the next, it may believe an audit is warranted. Similarly, when a state notices the absence of common property types for a particular industry in a holder's report, it may proceed with an audit.

Regardless of whether a business is aware of its unclaimed property reporting obligations, has failed to properly comply with such obligations or has consistently reported as accurately as possible, it may receive a letter of notification from a state that the company is under audit.

AUDIT LETTERS

As with many aspects of unclaimed property compliance and enforcement, audit letters also differ by state. However, several critical pieces of information are included in a typical audit letter that help recipient holders begin to understand the audit and their responsibilities. Details may include:

THE TYPE AND SCOPE OF THE AUDIT

An audit notice will generally include the business entities and property types under examination. The details may specify certain subsidiaries and property types, such as general ledger or securities, or may be all-inclusive, covering all corporate entities and all property types subject to reporting.

THE PARTY CONDUCTING THE EXAMINATION

The notice usually specifies whether a state representative or a third-party auditor will conduct the audit. Many states retain the services of outside auditors, such as Kelmar Associates, Specialty Audit Services, Innovative Advocate Group, Discovery Audit Services, and Kroll Government Solutions, to name a few.

PERIODS UNDER REVIEW

Audit letters often specify the number of years included in the examination. Audit lookback periods frequently span as many as 10-15 years.

RECORDS DESTRUCTION HOLD NOTICE

To ensure that the auditor has access to the records it believes are necessary to assess the audit subject's liability, the audit notice may include instructions to maintain specific records, such as bank statements, bank reconciliations, outstanding checklists, general ledgers and other essential documents.

STATUTORY REFERENCE AND NOTICE OF POTENTIAL PENALTY AND

The letter may cite the statutes that authorize the state to conduct examinations and indicate that holders may be subject to penalties and interest assessments based on the audit findings.

INSTRUCTIONS FOR PROCEEDING

The audit letter will likely include the next steps in the audit process so the recipient can prepare and respond promptly.



AUDIT PREPERATION

While undergoing an examination, the company may receive additional audit letters. Because third-party auditors often work for multiple states and are often paid on a contingency fee basis, other state clients may be solicited to join an audit. In addition to multi-state audits under a single auditor, states may separately identify a holder who happens to be under examination and begin their own audit. In either case, the audit subject will receive additional letters notifying it of the expanded scope or additional audits.

AUDIT DEFENSE TEAM

Unclaimed property audits are inherently complex, and it is essential to establish a team to advise and assist. Identifying audit defense team members support quickly responding appropriately to the audit letter and preparing for the subsequent work required to research questions and gather records throughout the audit process. This team should include outside counsel, consultants, and the company's internal departments.

Outside counsel specializing in unclaimed property can also provide valuable analysis of the company's contractual obligations, the creation of legal privilege for work papers and communications, preservation of legal rights, and the negotiation of nondisclosures, and settlement and release agreements. These protections help minimize the holder's risk throughout the audit process and after the audit has ended.

An unclaimed property consultant has expertise in managing the audit process and limiting its effect on the holder organization. A consultant can ensure that the overall process is fair, auditors don't overstep their authority, deadlines and document requests are reasonable and timely met, and audit methodologies are permissible. When the company and auditor disagree about data

quality and supporting documentation, a consultant can help resolve such differences efficiently and effectively.

Additionally, a full-service consulting firm can provide other highly specialized resources to help reduce the workload and exposure. This can include owner reunification teams focused on locating owners and reducing populations of past due property, IT professionals to assist with heavy data lifts or system challenges or staffing solutions to assist with the workload. These additional services can also help reduce the impact on a company's resources.

Because an audit typically includes requests for records from several departments, the audit team should include representatives from each affected area. Including team members from key departments ensures a division of responsibilities and an efficient response. Affected departments will depend on your industry but often include legal, tax, compliance, payroll, accounts payable, accounts receivable and corporate accounting.

Establishing who will serve as the auditor's point of contact is critical. This team leader should work with outside counsel and consultants to contact the auditor to understand the audit process, expectations, and timelines. If a third-party auditor is conducting the examination, putting a non-disclosure agreement (NDA) in place before responding to record requests is critical. An NDA safeguards sensitive data and maintains the holder's legal and ethical responsibility to protect personal information contained in its records.

COMMUNICATION, EDUCATION AND PLANNING

Unclaimed property audits can last multiple years, so spending time on the front end to educate the impacted departments can go a long way toward preparing them for success. Holding initial meetings helps educate each department on the process and allows them to plan for the expected impact. If your team includes experienced consultants or counsel, they can help walk through the audit phases and discuss expectations, estimated timelines, records requested, testing procedures, estimated workload, and other key topics that will allow for proper planning. This can also be a time to highlight how their efforts can help limit exposure to the company.

Lastly, communication with leadership is also important. Helping your leadership team understand the audit process, resource impacts, and potential exposure will significantly secure their support and prepare them to participate in the strategic decisions needed during each audit phase.



AUDIT PHASES

Now that we have explored the environment in which unclaimed property occurs and what to do upon receipt of an audit letter, let's look at the audit process and how a typical audit assessment is calculated.

PHASE 1: INITIATION

The audit process begins when a holder receives an audit letter alerting the business that it is the subject of an unclaimed property examination. The letter may specify the immediate next steps, including who will conduct the audit – a state auditor or a third-party audit firm. The designated auditor will often follow the letter with a communication to establish contact with the holder. This communication will typically include an initial information request. Some auditors schedule a kickoff call to discuss the process and ask initial questions. During the initiation stage, a non-disclosure agreement (NDA) should be executed if the audit is being conducted by a third-party auditor. A detailed discussion on NDAs is beyond the scope of this white paper. However, here are some important items to consider when a third-party auditor is involved:

- Legal counsel should be consulted to ensure that appropriate protections for the holder are included in the NDA.
- A holder should not provide information to the auditors or participate in the kick-off call until the NDA is in place.

Before moving out of the initiation phase, the holder should ensure they are aware and in agreement with the significant details of the audit. These typically include, but are not limited, to:

Type or focus of the audit
(general ledger,
Securities, etc.).

Target of the audit (parent
company, subsidiary, all
operational entities, etc.).

Party conducting the
exam.

Periods under review.

Records destruction
notices.

In most cases, these details are straightforward. However, the facts about the holder may change these details and should be fully understood before moving into the next audit phase.

PHASE 2: SCOPING

After the preliminary initiation steps are complete, the auditor will request records to help determine the audit scope, including the entities, property types and years of available records. Specific requests may vary by industry but typically include tax filings, state apportionment schedules, merger and acquisition history, trial balances, shared service information, unclaimed property policies and procedures, and record retention policies.

PHASE 3: TESTING AND REMEDIATION

Next, the auditor will conduct a detailed record review. This phase is often the bulk of the exam and is intended to identify the holder's unclaimed property liability for the jurisdiction(s) and years covered in the audit. As with the information requests during the scoping phase, source data requests also vary by industry. However, such requests typically include bank records, check registers, aging reports, account listings, suspense account balances and general ledger detail.

The auditor will analyze the source data and organize checks, credit balances, suspense balances and other accounts into populations for review. Population examples include:

Disbursements: Outstanding checks aged beyond 90 days and voided checks aged beyond 30 days before being voided.

Accounts Receivable: Credits aged beyond 90 days that no longer appear on customers' accounts.

Accounts: Other accounts that have not had activity within the designated dormancy period.

When adequate records are unavailable, the auditor may include estimation populations, which will be discussed below. For some industries, the auditor may attempt to use outside databases, such as the Social Security Administration's Death Master File or National Change of Address database, to help identify potential unclaimed property.

After establishing populations, the auditor asks the holder to review them and provide supporting documentation to show that the items included are not unclaimed property. This is often the longest and most laborious part of the audit. Populations can include thousands of items that require research. Once research efforts are exhausted, the holder needs to send due diligence mailings in accordance with state statutes for any property that will be reported through the audit.

Items that the holder cannot resolve during this phase will be used to determine the audit liability. These items may include actual property to be reported and property that contributes to estimation calculations. It is important to understand that the audit methodologies used by many states will often result in items being identified as unclaimed property that may not actually be unclaimed.

This occurs when the holder cannot research transactions and provide sufficient support to demonstrate that the liability was resolved in the ordinary course of business (e.g., proof a check cleared or was voided for cause).

PHASE 4: CLOSING AND SETTLEMENT

During the final phase, the holder works with the auditing states and auditor to establish the settlement amounts, remit unclaimed property to the states and close the audit. Negotiation may occur during the settlement process to calculate the total audit liability. The holder may also negotiate closing and settlement agreements to include penalty and interest waivers, protections against being audited for prior periods and other considerations that weren't negotiated at the beginning of the audit. The auditor may provide a closing letter summarizing the audit's scope and confirming its completion.

AUDIT EXPOSURE

A holder's overall audit exposure derives from audit liability and the cost of resources needed to complete the audit. Audit liability includes unpremeditated property identified during the audit and owed to the states, estimated liability for property lacking adequate records, and potentially penalty and interest assessments for past due property.

Estimation typically applies when the holder's state of incorporation is involved, and records are unavailable for a portion of the audit lookback period.

Using available years' records, the auditor applies estimation methodologies to calculate liability for the years where records are unavailable.

These estimations are treated as "unknown owner" property to be escheated to the holder's state of incorporation. In most cases, the estimation includes transactions for all jurisdictions, not just the audit states or the holder's state of incorporation. This results in the state of incorporation receiving the full amount of estimation for the periods where records do not exist.

During the testing and remediation phase, the auditor creates a population of records for the years for which records are available. The holder then researches the population to demonstrate that the items were resolved. Unresolved items determine an error rate or escheat percentage that is applied to a benchmark, e.g., the total sales for the years when records are unavailable. The auditor may include items properly reported as unclaimed property as errors in the calculation. This can result in a large, estimated liability calculation even when findings of actual unreported unclaimed property are minimal.

In addition to the holder's liability, internal resources represent substantial audit costs. Audits are highly detailed and require large amounts of records and significant research from several departments, including IT, accounting, tax, and legal. The process requires staff to shift their time and focus away from the holder's core business throughout the audit, which can span many years.

DEFENSE STRATEGIES

AUDIT DEFENSE TEAM

Successfully navigating an unclaimed property audit is complex, so the importance of having an experienced audit defense team in place cannot be understated. Knowledgeable advocates understand the auditors' playbook and the intricacies of how a company's specific circumstances impact their audit exposure (industry, merger and acquisition history, past software system migrations, compliance history, record retention, accounting practices, etc.).

Key advocates include unclaimed property consultants and attorneys. Consultants ensure the audited company is treated fairly, monitor auditor activities to enforce acceptable guardrails, verify that record requests and audit methodologies are reasonable, and help resolve conflicts regarding data quality and supporting documentation. Attorneys provide legal expertise, assisting with contractual obligations, legal rights, non-disclosure, settlement and release agreements, and expert guidance regarding other legal issues.

Within the audited company, the internal team lead should be the company's go-to unclaimed property champion. The internal champion understands the importance of unclaimed property compliance, as well as the financial and reputational risks when subjected to an audit.

The internal champion helps affected departments recognize the importance of prompt and complete record request fulfillment and serves as the primary liaison between the business and the audit defense team.

COMMUNICATION PROTECTIONS

Attorney-client privilege ensures that all information communicated between attorneys and their clients remains confidential. However, in some cases, such as when undergoing an audit, it may be prudent to expand the scope of this confidentiality to include non-attorney consultants. Kovel agreements allow for the extension of attorney-client privilege to include third parties serving as the attorneys' agents. If an unclaimed property audit leads to litigation, this protection may shield sensitive communications that could otherwise be available to the state.

Data security and confidentiality are also vital when transferring sensitive information between parties. Increasingly stringent data security and privacy laws and regulations add another layer of risk for companies handling sensitive information about customers, vendors, and other parties. Because the audit process includes exchanging records that contain potentially sensitive information, members of the audit team should transfer data using only secure methods.

RISK ASSESSMENT

Once the audit defense team and communication protections are in place, conducting a pre-audit assessment will clarify the company's overall unclaimed property status and the issues an auditor may uncover during the audit. A risk assessment provides information that will assist in developing an effective audit defense strategy and allows the holder to begin addressing deficiencies.

Unclaimed property consultants typically conduct the risk assessment, applying their expertise to understand and evaluate the holder's compliance strengths and weaknesses. The assessment:

- Establishes a thorough snapshot of the business and industry.
- Outlines the company's methods for identifying and reporting unclaimed property.
- Identifies process gaps and potential risks.
- Provides an understanding of record availability for audit purposes.
- Estimates potential financial exposure under audit.
- Recommend action steps to resolve gaps and mitigate exposure.
- Provides the baseline information needed for developing key audit defense strategies.
- Identifies risks in non-audit states and helps create a full state risk mitigation plan.

MANAGING SCOPE AND ESTABLISHING POSITIONS

Coming out of the risk assessment, the audit defense team will understand the applicable unclaimed property statutes for the respective audit states and the audit scope. This will allow the team to manage the scope of the audit effectively.

An understanding of the audit scope should include knowledge of:

- The participating states.
- The audit lookback period for each state.
- The entities and business units to be reviewed, including which entities may be subject to estimations (i.e., considering record availability, state formation, the applicable state statutes, and other details.
- The property types included in the review.
- The holder's reporting history including prior audits and VDAs.



Before responding to detailed records requests, it will be important to have clear and documented positions to help prevent overreaching requests. A few considerations include:

- The types of transactions, products, etc., subject to unclaimed property.
- Statutory language pertaining to items such as exemptions, preemptions, deductions, contractual terms and conditions, etc.
- Actions or data points that may impact dormancy or reporting requirements (owner activity, returned mail, death, etc.).
- Merger and acquisition history and the impact on unclaimed property reporting obligations.

Agreeing with the auditors before proceeding with detailed audit requests can be helpful in some cases. While formal documents, such as Audit Resolution Agreements, may be created by auditors to document agreements on important matters, your legal team should carefully read these documents in consultation with your unclaimed property advocates.

SETTING EXPECTATIONS

Setting expectations early in the examination is crucial. Companies should be professional and cooperate with reasonable auditor requests but also assertive and proactive to protect the company. Consider the company's resources, business cycles, and other constraints, and establish reasonable timelines and response expectations with the auditors.

Establishing expectations upfront reduces the chances of unreasonable requests from the auditors during the audit. Require that all agreed-upon terms be documented in writing. Such documentation can be used to push back if an auditor attempts to overstep terms as the audit proceeds. If disagreements with third-party auditors cannot be mutually resolved, work with the state administrators to seek reasonable solutions.

DEFENSE STRATEGIES

OVERREACHING REQUESTS

When the audit is underway, the auditor will request company records for review. The auditors will use the records you provide to determine the company's level of compliance and potential liability. Before responding, closely review these requests and challenge those that are overly broad or fall outside the agreed-upon review parameters. Maintain a spirit of cooperation and communication but beware of unreasonable requests. Having the established positions discussed above will help prepare you for these requests and responses.

COMPLETENESS AND RESEARCHABILITY

To understand record availability for each in-scope entity and property type, limit submissions to periods where available records are complete and researchable. This will be important for the remediation efforts and estimations discussed below.

EXPEDITED APPROACHES

Auditors have standard testing procedures for most property types and will request records based on these procedures. However, they do not always apply or may not be the most effective way to accomplish the process for your situation. Working with knowledgeable advocates who understand these procedures and their objectives will allow you to take what you know about your company and negotiate expedited testing approaches that may limit time and unnecessary work for you and your colleagues.

ESTIMATIONS

Depending on your circumstances, the auditor may extrapolate estimated liability for past unclaimed property amounts by testing a sample from the available records. It is not uncommon for estimated liability to be the largest portion of a company's exposure under audit. Understanding how the sampling and estimation models work and what factors will increase or decrease the estimations will be important. The process is subjective, and many decisions made early in the

audit may impact estimations. Thus, it is crucial to understand these factors and consult with advocates before providing any records or responses to auditors.

REMEDIACTION TACTICS

Auditors will use the records provided to them to create populations or samples that contain items they believe represent unclaimed property. The selected items will generally be considered unclaimed property unless documentation can be provided by the holder that proves the

obligation is no longer owed or does not represent unclaimed property.

- Do not blindly accept populations or samples from auditors. Review them and ensure they are free of errors or other issues (exemptions, preemptions, sampling issues, scope, transactions, etc.).
- Identify categories or types of transactions that could be broadly removed or excluded based on business cases or other explanations.
- Work with the auditors to understand and agree on what documentation is acceptable to support resolutions.
- Educate and train the internal team researching the populations.
- Understand how individual items impact the overall liability calculations and prioritize high-value items.

REVIEW AND REBUT FINDINGS

Request a written explanation of testing and calculation methods and dispute any miscalculations. Consider your company's unique circumstances and processes and present your case and why the auditor's findings may not accurately reflect your true liability. If resolutions cannot be completed with the auditors, attempt to resolve matters directly with the states.

LEVERAGING THE AUDIT WORK FOR FULL COMPLIANCE

Unclaimed property audits often require a significant amount of cost and effort to complete. Companies that have gaps in compliance or no reporting history should not waste this effort. When handled proactively, the work used to support the audit can be leveraged to come into compliance with the remaining states not included in the audit. As mentioned previously, many states have programs for reporting past

due property voluntarily to assist with securing penalty and interest waivers and other protections. The expectations and requirements for these programs vary by state, but a sophisticated audit defense team with working experience in state amnesty programs can seamlessly utilize the audit work to establish a full state compliance plan.

In conclusion, effectively navigating an unclaimed property audit requires a proactive and strategic approach to minimize financial and operational risks. By understanding the audit process, assembling the right team, and implementing best practices for audit preparation and defense, companies can effectively manage the complexities of an audit and safeguard their interests. Taking the time to properly prepare and manage the audit process will not only help mitigate potential liabilities but will also position the organization for long-term success in managing unclaimed property compliance obligations.

