
Unclaimed Property: A FAS 5 Minefield

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An article published last year in the Wall Street Journal, "States Scooping Up Assets from Millions of Americans: 'Unclaimed Property' Fattens Public Coffers," highlights states' increased enforcement of unclaimed property laws.¹ In 2006, Waste Management, Inc. paid \$20 million before tax to settle unclaimed property obligations going back as far as 1980.² The Waste Management audit started with a notice covering items such as uncashed payroll checks. These items demonstrate the risks of ignoring unclaimed property laws.

Unclaimed property typically results from the failure of an entity or person who is legally entitled to property to make a valid claim against the holder of the property (business) within a prescribed period of time. Basically, unclaimed property laws require businesses that have unclaimed property to report and remit such property to the appropriate state or states.

Many companies are not in compliance with unclaimed property reporting requirements but have performed a

self-assessment of the potential liability and determined that it is not material. Recent case law and experience with unclaimed property audits suggests that many companies' self-assessments significantly understate the potential exposure that companies have as a result of possessing unclaimed property. A complete risk assessment is the key to reducing a company's unclaimed property exposure.

Defining Unclaimed Property

Common types of unclaimed property include unredeemed gift certificates, vendor credits, and outstanding checks, such as payroll and dividend checks. Although the laws regarding unclaimed property have existed for decades, enforcement has been inconsistent. States have had a limited number of auditors and focused their enforcement efforts on financial institutions and insurance companies. Owing to state revenue shortages and states' use of contract auditors, however, unclaimed property audits in the last decade have expanded beyond the financial and insurance industries.

Every state has some form of unclaimed property law. Although tax departments are often charged with responsibility for supporting unclaimed property audits, state unclaimed property claims are not taxes. Rather, the basic assumption underlying unclaimed property laws is that the enterprise is holding property belonging to someone who is legally entitled to the property. In many states there is no unclaimed property equivalent to taxpayers' rights, and no nexus requirements circumscribe an enterprise's potential liability. In addition, often there is no statute of limitation with respect to unclaimed property.

Although FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes,"³ an interpretation of FASB Statement 109, "Accounting for Income Taxes,"⁴ does not require companies to recognize and measure positions taken with respect to sales and use tax, excise tax, property taxes, or unclaimed property, the disclosures required by the interpretation may well be of interest to federal, state, and local non-income tax auditors. For example, a North Carolina unclaimed property auditor might be

very interested to learn that a company has income tax exposure in Texas but is not filing any unclaimed property reports in North Carolina.

Typically, if the enterprise has the complete last known address of the owner of the property in question, the state of the last known address has priority on the reporting of such property. For example, if a company has a complete address on file for the owner of an uncashed dividend check, and that address is in Portland, Oregon, the company may have an obligation to report the unclaimed property to Oregon – even if the company has no physical presence in Oregon and no tax filing requirements there. If the entity has only an incomplete address, or no address at all, for the property owner, the property likely defaults to the entity’s state of organization or incorporation. For example, if a corporation is incorporated in Delaware but commercially domiciled in Indiana, the property will default to Delaware and not Indiana.

The Role of FAS 5

Since unclaimed property claims do not constitute a tax, Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies” (FAS 5)⁵ may affect an enterprise’s financial reporting obligations. In FAS 5, the term “contingency” is defined as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a ‘gain contingency’) or loss (hereinafter a ‘loss contingency’) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” Not all uncertainties give rise to FAS 5 contingencies. For example, that the true useful life of a specific machine cannot be known ahead of time does not cause the depreciation on that machine to be a contingency.

According to FAS 5, a contingent loss should be charged to income if information is available before issuance of the financial statements indicating by fiscal year-end that a loss probably has been incurred and that the amount of such loss can be reasonably estimated. If there is a reasonable possibility that the loss will be incurred, FAS 5 generally requires the disclosure in the footnotes of the financial statements to include a discussion of the nature of the loss and

either the possible range of the loss (if it can be estimated) or a statement that such loss cannot be estimated.

FAS 5 provides: “Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.” As used in FAS 5, the term “remote” means “the chance of the future event or events occurring is slight.” The term “reasonably possible” means that the chance is “more than remote but less than likely.” The term “probable” indicates that “the future event or events are likely to occur.”

Addressing Unclaimed Property FAS 5 Issues With the Auditors

Most companies have a range of unclaimed property exposure. Some items are so clearly escheatable that FAS 5 does not apply, since there is no contingency other than one: that the liability will not be discovered by the appropriate state officials. FAS 5 does imply that where there is no awareness of the potential claim and where the successful pursuit of such a claim is improbable, disclosure may not be required.

Even if FAS 5 can be interpreted to support such a position, it may not be advisable to be an officer of a company that takes the position that there was no requirement to accrue a liability on the balance sheet because it was improbable that the company would be audited for unclaimed property. For example, a new chief financial officer (CFO) analyzes the payroll liability and discovers uncashed payroll checks totaling \$43,125 that had been issued five years earlier to employees with addresses in State X. State X has a one-year dormancy rule for payroll checks. Unless one takes the probability of audit by State X into account, the \$43,125 of liability clearly should remain on the company’s balance sheet.

Assume that this same CFO discovers that checks totaling \$155,300 are outstanding to vendors with addresses in State X, that they were written off in the prior year, that the issue date on

each of these checks is from a period before the state’s dormancy period for such property ends, and that the company has had no contact with these vendors during the dormancy period. If the CFO finds some evidence that \$75,000 of these checks were reissued, what amount should the financial statements list as the unclaimed property liability to State X for the outstanding checks?

It would appear that at a minimum \$80,300 of the \$155,300 should be due State X unless the CFO wants to argue that this amount is contingent because the probability of discovery by State X is low. The \$75,000 of the potential liability would be governed by FAS 5. If the CFO determines that the evidence is strong that the checks were reissued, he might argue that the remaining \$75,000 should not be included in the unclaimed property liability and that no disclosure in the footnotes is required. If there is some evidence that the checks were reissued, but the evidence is not very strong, the CFO may argue for disclosure of the potential \$75,000 of liability in the financial statements’ footnotes and give a range of dollar amounts for the company’s potential liability.

This range (\$80,300 to \$155,300 in the example) may not be the complete unclaimed property liability for State X. If the company has not filed unclaimed property reports in State X, there may be additional liability to accrue. Although most states will enter into an unclaimed property voluntary disclosure agreement (VDA) with a company, they require a company to file at least 10 years of reports unless the company has not existed for 10 years. Since many types of property have a five- to seven-year dormancy period, a company would have to have at least 15 to 17 years of detailed records in order to support 10 years of reports. Generally, if complete records are not available, states require the company to use the available data to determine an error rate for each type of property and extrapolate the liability based on this rate for the years with incomplete records. Furthermore, some states use a longer look-back period if they contact the company before the company requests a VDA from the state. Most states impose a penalty, and some impose interest on late payments of unclaimed property if the state contacts

the company first. Since these amounts are extrapolations, the calculated liabilities are generally not reflected in the financial statements. Typically, because of lack of detailed records, the extrapolated liability greatly exceeds the actual amount of unclaimed property found in the existing records.

Under the preceding scenario, to avoid having to accrue additional liability in State X for interest, penalty, and in some states a longer look-back period, the CFO would have to establish that the company had not been contacted by State X and that the company is planning to request a VDA with State X. Furthermore, because of the number of records involved, this process could go beyond one fiscal year.

Traps for the Unwary: Three Examples

Unclaimed property audit experience and recent case law suggest that the amount of unclaimed property represented on the balance sheet might be only the tip of the iceberg.

Delaware. A recent lawsuit in Delaware demonstrates how the holders and the state can disagree on the method used to calculate the amount of unclaimed property owed to the state. In the Opening Brief in Support of Defendants' Motion to Dismiss the Verified Complaint, *CA, Inc. v. Cordrey*,

the Statement of Facts indicates that CA, Inc., originally filed a VDA with Delaware with an offer of \$684,035.94.⁶ The corporation later revised the offer to \$2,323,880.08.

Delaware did not accept the revised offer and initially requested that CA pay \$7,628,106.11. After a counteroffer by CA, Delaware requested interest in addition to the unclaimed property for a total assessment of \$8,218,410.46 and notified CA of the state's intent to conduct an unclaimed property audit. Finally, CA filed a complaint in Delaware Chancery Court requesting relief from Delaware's assessment.

In arguing for dismissal of CA's complaint, Delaware asserts that the Court of Chancery has jurisdiction only to review assessments of penalty and interest and not good-faith assessments of unclaimed property. In the Verified Complaint for Equitable, Declaratory, Injunctive, and Other Relief, *CA, Inc. v. Cordrey*,⁷ CA asserted that a large difference in the state's calculation of unclaimed property liability was a result of its using estimates to compute certain portions of the liability, even though CA had provided the state with evidence of actual names and addresses.

This case shows how radically different a company's self-assessment and a state's determination of unclaimed property liability can be. It also demonstrates that

the VDA process has some significant benefits but also some potential risks.

Two California Cases. Two other cases demonstrate that other potential unexpected liabilities can arise from unclaimed property laws. In *Vondjidis v. Hewlett Packard Corp.*, the California Court of Appeals reversed and remanded a lower court's grant of summary judgment in favor of Hewlett Packard.⁸ Hewlett Packard had the home address of shareholder Alexander Vondjidis but used his office location as the address of record. After his office was closed, Vondjidis received no stockholder information. Without contact with Vondjidis as a shareholder, Hewlett Packard turned the stock over to California pursuant to a provision of the state's unclaimed property law. Vondjidis later learned that the stock had been turned over to the state and sued Hewlett Packard.

Hewlett Packard asked for dismissal of the suit, according to the indemnification provisions of the unclaimed property laws. The court's decision suggests that a company might have a duty to scan all corporate records for the last known name and address. For example, the court noted that Hewlett Packard's personnel records included Vondjidis's home address and stated, "A corporation cannot shield itself from knowledge of its own



records by establishing a practice that sacrifices its shareholders' interests to the corporation's convenience." Thus, the due diligence process required under unclaimed property laws could very well be more extensive than many believe, especially with respect to stock of publicly traded companies.⁹

A 2006 California Supreme Court decision raises the bar for potential liability exposure for a company that ignores the unclaimed property laws and decides to come into compliance with those laws only if it is caught by the state. In *California v. PricewaterhouseCoopers, LLP*, the City of San Francisco and the County of San Francisco (City) sued PricewaterhouseCoopers LLP (PwC) pursuant to the *California False Claims Act* (CFCA) and unfair competition law.¹⁰ The CFCA has a *qui tam* feature that permits a person with independent knowledge to bring a suit in the name of a defrauded government entity. If the *qui tam* suit is successful, the person bringing the suit on the government's behalf is awarded a portion of the amount recovered. The CFCA also contains a treble-damages provision.

The City originally sued Old Republic Title Company under the CFCA and several other statutes, alleging that Old Republic had falsified unclaimed property reports to the state controller and had failed to remit dormant escrow funds. Old Republic conceded liability on the CFCA count with damages of \$7.568 million, which were tripled to \$22.704 million. The court awarded the City one-third of the tripled damages,

\$7.568 million. The City then amended its complaint to include PwC, arguing that, as Old Republic's independent public accountant during the periods in question, PwC was liable for failure to disclose in its independent audit reports Old Republic's escheat violations.

The California Supreme Court held that the Court of Appeals erred in determining that the City was a "person" for purposes of *qui tam* litigation and dismissed the suit. Although PwC won, the decision implies that both the company and the independent auditor could be liable under false claims statutes if a company ignores unclaimed property laws and a disgruntled employee or former employee sues under a *qui tam* suit.¹¹

It's Better Not to Learn the Hard Way

Experience teaches that companies often have no formal process for reviewing unclaimed property. When a company does have a process, inappropriate design often makes it ineffective. For example, having a process that provides only for a simple review for uncashed checks, accounts receivable credits, unredeemed gift certificates, and similar unclaimed property – along with the assumption that the unclaimed property liability is the sum of these items – could be problematic for the company.

The absence of records for all years and the level of evidence that some states require can yield a liability that is significantly higher than an initial review would indicate. Thus, if a

company has not been in compliance with unclaimed property laws in the past, it might not believe it is worth the effort to fully assess its unclaimed property exposure. Recent case law clearly contradicts this assumption and demonstrates that unexpected and significant consequences can be the result of a failure to perform a complete risk assessment in this area.

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¹ Scott Thurm & Pui-Wing Tam, Wall Street Journal, Feb. 4, 2008.

² Waste Management, Inc., Securities and Exchange Commission, Form 8-K, Feb. 8, 2007.

³ Federal Accounting Standards Board Interpretation No. 48, www.fasb.org/pdf/fin%2048.pdf.

⁴ Statement of Financial Accounting Standards No. 109, www.fasb.org/pdf/fas109.pdf.

⁵ Statement of Financial Accounting Standards No. 5, www.fasb.org/pdf/fas5.pdf.

⁶ Opening Brief in Support of Defendants' Motion to Dismiss the Verified Complaint, *CA, Inc. v. Cordrey*, C.A. No. 4111-CC (Del. Ch. Nov. 2008).

⁷ Verified Complaint for Equitable, Declaratory, Injunctive, and Other Relief, *CA, Inc. v. Cordrey*, C.A. No. 4111-CC (Del. Ch. Oct. 2008).

⁸ *Vondjidis v. Hewlett Packard Corp.*, H030806 (Santa Clara County Super. Court No. CV815388).

⁹ *Id.*

¹⁰ *California v. PricewaterhouseCoopers, LLP*, CA Sup. Ct. S131807, Aug. 31, 2006.

¹¹ *Id.*



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