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Webinar Series

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BDO KNOWLEDGE Tax Webinar Series

Texas Update: Audit Invasion

National Unclaimed Property Practice, BDO USA, LLP

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October 28, 2014

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WITH YOU TODAY



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AGENDA

1. Unclaimed Property Overview
2. Urgent - Texas Kelmar Audit - Impact on Texas Public Companies
3. Testing Methodologies and Extrapolation Calculations
4. Audit Technique Nuances
5. Voluntary Disclosure/Amnesty
6. Questions
7. Save the Date

UNCLAIMED PROPERTY OVERVIEW

UNCLAIMED PROPERTY TYPES

All 50 states and the District of Columbia have enacted unclaimed property laws.

Examples of unclaimed property:

- ▶ Uncashed payroll or commission checks
- ▶ Uncashed payable/vendor checks
- ▶ Gift certificates/gift cards
- ▶ Customer merchandise credits, layaways, deposits, refunds or rebates
- ▶ Overpayments/unidentified remittances
- ▶ Suspense accounts
- ▶ Unused/outstanding benefits (non-ERISA)
- ▶ Credits written off to miscellaneous income/bad debt expense account

UNCLAIMED PROPERTY TYPES (CONTINUED)

All 50 states and the District of Columbia have enacted unclaimed property laws.

Examples of unclaimed property, specific to the oil and gas industry:

- ▶ Royalties held in suspense due to title disputes, pending litigation, etc.
- ▶ Demurrage Claims due to delay in lay time
- ▶ Gas Imbalances resulting in future settlement through cash payout/receipt or future delivery/receipt.

PRIORITY RULES

The U.S. Supreme Court in *Texas v. New Jersey*, established the following unclaimed property jurisdictional priority rules:

- ▶ First, to the state of the *owner's last known address*, if known, or
- ▶ Second, to the state of the *holder's corporate domicile* (i.e., state of incorporation for incorporated entities and state of formation/principal place of business for unincorporated entities).

UNCLAIMED PROPERTY INTRODUCTION

Various States' Dormancy Periods

“Dormancy Period”: A state prescribed period that begins from the date of creation of the property type (e.g., issuance date for checks) and ends on a certain legislatively defined date (e.g., typically 1-5 years) which measures a period of time for which that property incurs no activity. Some examples include the following:

State	Wages (years)	A/R Credit Balances (years)	Third Party Dividends (years)	Stocks (years)	A/P Checks (years)	All other property (years)	B2B
DE	5	5	5	3	5	5	No
TX	1	3	3	3	3	3	No - Deferral Available

URGENT – TEXAS DOMICILED COMPANIES AT HIGH RISK FOR UP AUDIT BY TEXAS

URGENT - TX DOMICILED COMPANIES AT HIGH RISK FOR UNCLAIMED PROPERTY AUDIT BY TEXAS

Risk overview

- ▶ Various third-party audit firms hired by Texas to perform UP audits
- ▶ RFP went out in 2013, Performance begins 9/1/2013
- ▶ Audits have already started
- ▶ Third-party audit firms paid 10%-12% commission on findings
- ▶ LA, AR, OK and KY are also hot spots for audits (see attached audit list)
- ▶ No general SOL period
- ▶ Look-back period is 13 years or to date of incorporation (discretionary to state)
- ▶ Interest - variable rates
- ▶ Penalties - 10%

Impact to clients

- ▶ Extrapolation giving rise to Million dollar assessments
- ▶ Significant P&L hit as clients are not "reserved" for exposure
- ▶ Piggyback other states = multistate audit
- ▶ Piggyback DE onto the audits, now 2 very difficult states TX and DE
- ▶ Aggressive pursuit of "voided checks" and "a/r credits"

URGENT - TX DOMICILED COMPANIES AT HIGH RISK FOR UNCLAIMED PROPERTY AUDIT BY TEXAS (CONT.)

- ▶ RFP 206e Unclaimed Property Audit Services - Open Date: 06/21/13 02:00 PM Agency Requisition Number: 206E
- ▶ Pursuant to Chapters 403 and 2254, Subchapter A of the Texas Government Code; and Chapters 72-75 of the Texas Property Code, the Comptroller of Public Accounts (€ Comptroller €) announces the issuance of its Request for Proposals (€ RFP #206e €) from qualified, independent unclaimed property audit firms to assist Comptroller in performing unclaimed property audit and related services for Comptroller, including but not limited to, the identification, processing, and collection of unclaimed property due to the State of Texas under Chapters 72-75 of the Texas Property Code. Comptroller reserves the right to award one or more contracts under this RFP. ***The successful respondent(s) will be expected to begin performance of the contract(s), if any, awarded under this RFP on or about September 1, 2013, or as soon thereafter as practical.*** The anticipated schedule of events is as follows: Issuance of RFP € May 10, 2013, 10:00 a.m. CT; Questions Due € May 24, 2013, 2 p.m. CT; Official Questions and Responses posted € June 7, 2013, or as soon thereafter as practical; Proposals Due € June 21, 2013, 2:00 p.m. CT; Contract Execution € August 1, 2013, or as soon thereafter as practical; and Commencement of Project Activities € September 1, 2013, or as soon thereafter as practical. The Comptroller reserves the right, in its sole discretion, to modify this schedule of events...

WHO ARE THESE THIRD-PARTY AUDITING FIRMS?

#	Firm	Comments
1	Kelmar Associates, LLC	Leading audit firm for DE and certain other states
2	UPCH	Owned by Xerox; maintain contracts with over 25 states
3	Audit Services US	Maintain contracts with 46 states
4	Verus Financial LLC	Leader in life insurance audits
5	Treasury Services Group LLC (TSG)	Bought bankrupt APEX; newer firm 2012-2013
6	Discovery Audit Services LLC	Newer firm outside LA; Performing audits for LA since 2003
7	Hertz & Hertz	Newer firm, started in 2012-2013
8	Innovative Advocates Group, Inc.	Newer firm, started in 2013

URGENT - TX DOMICILED COMPANIES AT HIGH RISK FOR UNCLAIMED PROPERTY AUDIT BY TEXAS (CONT.)

Below are some factors that put both private and public companies at risk for an unclaimed property audit:

- ▶ \$200M and above in annual revenue
- ▶ Incorporated in TX or DE
- ▶ Domiciled in TX
- ▶ No or little filing history of escheat reports with TX and other states
- ▶ Filing only negative reports
- ▶ Filing an initial report that only contains recent transactions (current due property)
- ▶ Recent mergers, acquisitions, reorganizations and reincorporation
- ▶ Received any notices from BART division in last 6 months regarding unclaimed property
- ▶ Under audit by another state
- ▶ Company or industry in the news
- ▶ Claiming unclaimed funds without having history of reporting
- ▶ Others in industry currently under audit
- ▶ Random selection

COMPUTERSHARE KELMAR AUDIT – IMPACT ON TEXAS PUBLIC COMPANIES

COMPUTERSHARE KELMAR AUDIT IMPACT ON TEXAS PUBLIC COMPANIES

Main issue:

- ▶ In approximately the last 6 months, Kelmar has issued an audit letter to Computershare, a third party stock transfer agent.
- ▶ The Computershare Kelmar audit is expanding to include the audit of Computershare's clients

Risks:

- ▶ Additional costs to retrieve data and cost of handling audit.
- ▶ Potential audit scope increase from equity transactions (e.g., stock) to general ledger transactions (e.g., accounts payable, payroll, accounts receivable, etc.)

Kelmar's focus:

- ▶ Shareholder accounts with addresses in the states Kelmar represents
- ▶ Date of last activity - How Computershare is applying the last activity date (trigger point) to calculate dormancy?
 - ▶ Shareholder activity vs. Return mail to calculate dormancy

TESTING METHODOLOGIES AND EXTRAPOLATION CALCULATIONS

TEXAS

Extrapolation Techniques

Texas does not appear to address estimation and extrapolation methodologies for unclaimed property reporting in statute, regulatory or administrative guidance. Texas generally follows unclaimed property estimation and extrapolation techniques followed by other states (*e.g.* Delaware).

EXPOSURE QUANTIFICATION

Payroll Extrapolation

Unremediated Payroll O/S Checks –
12/31/2004

Federal 1120 Payroll – 12/31/2004

= % x

Federal 1120 Payroll
(prior years)

EXPOSURE QUANTIFICATION

Accounts Payable Extrapolation

Accounts Payable O/S Checks -
12/31/2004

Federal 1120 Sales –
12/31/2004

= % x

Federal 1120 Sales
(prior years)

EXPOSURE QUANTIFICATION

Accounts Receivable Extrapolation

- ▶ If all sales are on account, the following extrapolation can be used:

$$\frac{\text{Unremediated Net Credits}^1 - 12/31/2004}{\text{Sales} - 12/31/2004} = \% \times \text{Sales (prior years)}$$

- ▶ Holder should review credits written off (e.g., to miscellaneous income/expense account) to any amounts of bad debt as this is a viable position to offset net credits that is often overlooked.

¹ In many cases the net credits were written off to miscellaneous income, allowance for doubtful accounts, or bad debt expense and documentation to prove it is not escheatable is unavailable.

EXAMPLE OF EXTRAPOLATION

Year	Sales	Total Unremediated Unclaimed Property	Unremediated Unclaimed Property w/ Delaware Address	Extrapolated Liability Sourced to Delaware	Total Delaware Assessment
2005	750,000,000	250,000	12,500	Use Actual Data	12,500
2004	700,000,000	650,000	5,500		5,500
2003	680,000,000	320,000	11,200		11,200
2002	675,000,000	90,000	8,300		8,300
2001	665,000,000	110,000	4,500		4,500
2000	550,000,000	Documents Unavailable	Documents Unavailable	225,072	225,072
1999	625,000,000			255,764	255,764
1998	600,000,000			245,533	245,533
1997	550,000,000			225,072	225,072
1996	540,000,000			220,980	220,980
1995	525,000,000			214,841	214,841
1994	510,000,000			208,703	208,703
1993	495,000,000			202,565	202,565
1992	475,000,000			194,380	194,380
1991	460,000,000			188,242	188,242
1990	425,000,000			173,919	173,919
1989	400,000,000			163,689	163,689
1988	390,000,000			159,597	159,597
1987	365,000,000			149,366	149,366
1986	345,000,000			141,182	141,182
1985	250,000,000			102,305	102,305
1984	275,000,000			112,536	112,536
1983	240,000,000	98,213	98,213		
1982	225,000,000	92,075	92,075		
1981	185,000,000	75,706	75,706		
Actuals	3,470,000,000	1,420,000	42,000	3,449,741	3,491,741
Error Rate		0.04092%			
Application of Penalties and Interest					4,364,676
Total Delaware Assessment					7,856,416

AUDIT TECHNIQUE NUANCES

TEXAS

Audit Provisions

The Comptroller, the attorney general, or an authorized agent of either, may at any reasonable time examine the books and records of any holder. No information obtained by an examination may be publicly disclosed except in the course of a judicial proceeding in which the state is a party or pursuant to an agreement with another state allowing joint audits or the exchange of information obtained pursuant to the examination.¹

¹Texas Property Code Sec. 74.702

STANDARD AUDIT METHODOLOGIES

Check Testing

- ▶ Consecutive Quarterly outstanding check listings, plus a master void list.
- ▶ Reconciliation of outstanding checks lists to bank reconciliation required.
- ▶ No void waiver policy for disbursements.
- ▶ Utilization of earliest years available regardless if fully researchable or not (e.g., per auditors - most indicative of historical practices and policies).
- ▶ System conversions not always respected, requesting testable data pre conversion common.
- ▶ Remediation support - **“strict liability”**
 - ▶ Original issue check - Voided check - Reissued check - Reissued Check Cashed
 - ▶ Only respected if can show same invoice # for each of the checks in the chain

STANDARD AUDIT METHODOLOGIES

A/R Testing

- ▶ Relying on tracer account results for testing of write-off accounts.
- ▶ Significant difficulty matching tracer “disposition GL account” (e.g., bad debt expense) line item detail to a customer # or name
- ▶ For AR netting purposes, each write-off account separately netted to identify exposure by account.
 - ▶ Reclass of debit invoice write offs - Bad Debt Expense
 - ▶ Reclass of credit write offs - Allowance for Doubtful Accounts
 - ▶ Which account would you guess would be selected on Audit?
 - ▶ What if my practice started only in 2005, but I have no records to prove my practice was different prior to 2005?
 - ▶ How far does “He said, she said go?”
- ▶ 1-2 year process for determining tracers in many cases

STANDARD AUDIT METHODOLOGIES

A/R Testing (Continued)

- ▶ No respect of “forfeiture clauses”, special billing practices agreed to with holder’s customers, etc. - based on “**private escheat**” grounds
- ▶ Remediation support - “**strict liability**”
 - ▶ **Bad Debt W/O with Subsequent Payment** - Reversal of bad debt invoice write off - put back on customer A/R account via journal entry - subsequent payment applied
 - ▶ **Estimate or Accrual** - show credit selected tied to journal entry for estimate purposes (e.g., accruing potential receipt of funds, % of completion, etc.)
 - ▶ **Settlement** - show credit resolved through legally binding settlement agreement
 - ▶ **Pricing Adjustments** - show sale of product & payment received in July was for \$10 based on June pricing sheet, but later determined July pricing sheet which was unavailable at time of P.O. was \$12, invoice booked on A/R at \$10, match payment of \$10 with \$2 write-off to pricing adjustments account on P&L - Can you show both pricing sheets, if yes item should be resolved
 - ▶ Only respected if can show same transaction (e.g., invoice), for same customer where adjustment made in contemporaneous fashion
- ▶ Providing report of examination as the first estimate of potential exposure for audit

NEW AUDIT METHODOLOGIES

- ▶ Many of the same techniques applied under “Old Audit Methodologies”
- ▶ Check register approach
- ▶ No void policy waiver
- ▶ Preference towards detailed review vs. sampling
- ▶ Qualitative review of GL accounts
- ▶ If holder unable to net accounts quickly, take gross credits for testing purposes, burden put on holder to find offsetting debits after the fact
- ▶ Issuance of audit letters for newly acquired entities
- ▶ Multiple audits running simultaneously by different 3rd Party Auditing firms and/or recycled audits
- ▶ State income tax divisions including “audit scoping type” questions on nexus or “doing business application forms”.

COMMON ISSUES WITH UNCLAIMED PROPERTY

Gross vs. Net - Numerator

- ▶ What is gross vs. net for the extrapolation calculation?
- ▶ The more logical vs. reality used in an audit
- ▶ Very difficult for holders to understand and accept which can lead to setting false expectations internally about potential risk exposure at CFO level

Base Periods - Important considerations

- ▶ What records are available?
- ▶ Are these years complete and researchable?
- ▶ What does “researchable” mean?
- ▶ What if I could recreate data to fill in holes?
- ▶ What if I have a check register that shows all checks written with addresses going back to 1995 and no DE addresses, am I done?

Voids Treatment - How do I deal with this?

- ▶ Is a master void list available?
- ▶ Texas does not allow a void waiver
- ▶ Remediation of Voids - Remember strict liability?

UNCLAIMED PROPERTY AUDITS

Audit Notice - Considerations

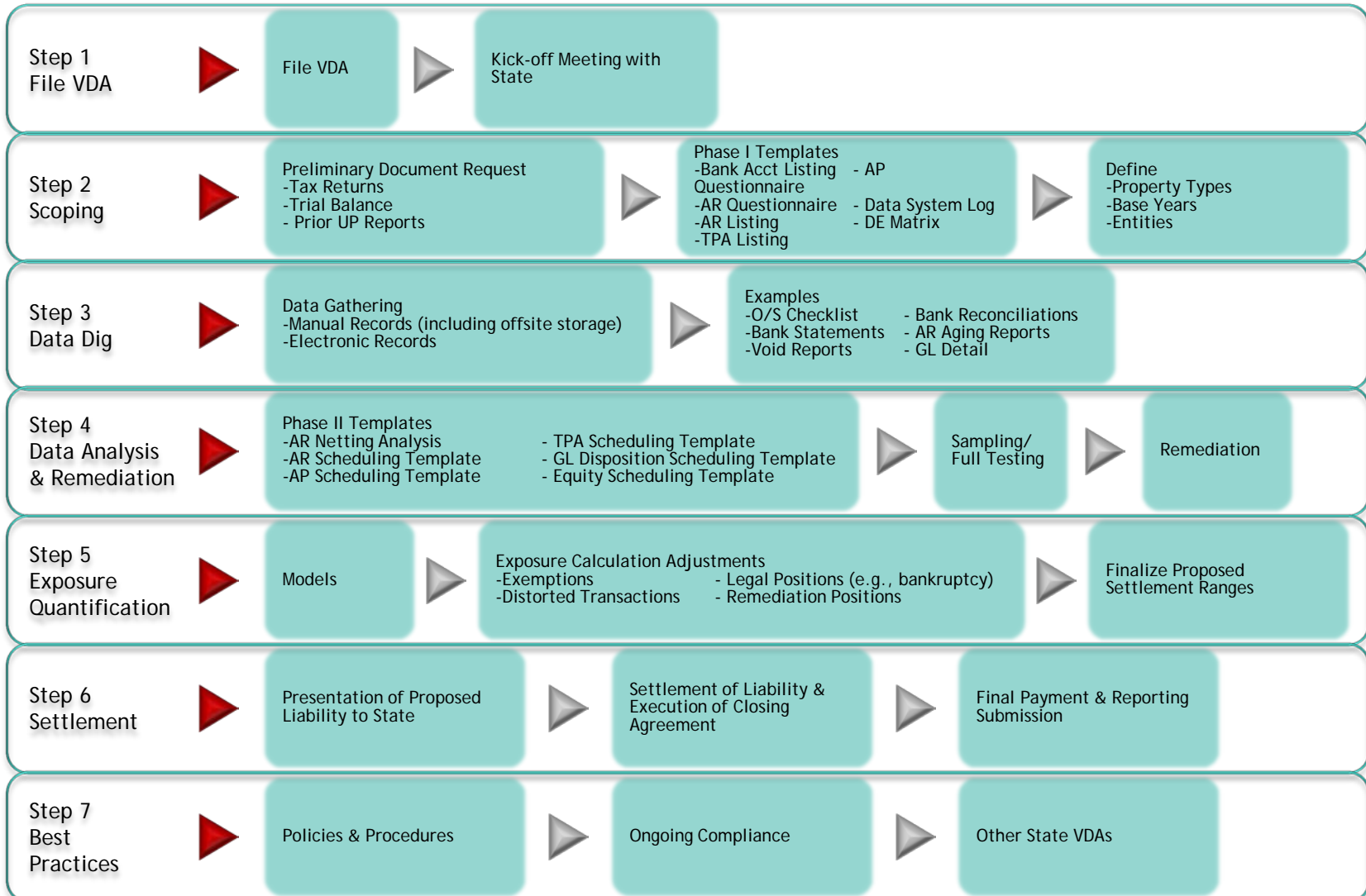
Upon notification of a pending audit, a holder should consider the following:

- ▶ Confirm auditor's authorization to conduct the audit
- ▶ Determine states included in audit
- ▶ Request agreement/contract between each state and contract auditor
- ▶ Lock down look-back period
- ▶ Lock down property types to be reviewed
- ▶ Confidentiality Agreement
 - ▶ Request confidentiality agreements from the third-party auditor and/or state(s)
 - ▶ Review states' statutory guidance on confidentiality
- ▶ Identify internal client project leader
- ▶ Consider entering into VDAs with states not included in the audit

BDO KNOWLEDGE Tax Webinar Series – Texas Update: Audit Invasion

VOLUNTARY DISCLOSURE/AMNESTY

TEXAS VOLUNTARY DISCLOSURE PROCESS



TEXAS VDA PARTICULARS

Audit vs. VDA

CATEGORY	TX VDA	Audit
Penalty & Interest	Waived	Up to max of 20% of assessment
Audit Waiver	Audit waived unless misrepresentation or fraud	N/A
Look-back	10 report years	The state can go back to date of formation or incorporation at their discretion, but may limit period to shorter time frame administratively
Who Conducts Review	Self review	Third party audit firm
Venue	Texas Comptroller of Public Accounts	Texas Comptroller of Public Accounts
Timeline	Less than 2 years	~ 3 to 6 years

ARKANSAS VDA PARTICULARS

Audit vs. VDA

CATEGORY	AK VDA	Audit
Penalty & Interest	Waived	Interest: Annual rate of 2 percentage points above prim loan rate Penalty: Max \$5,000
Audit Waiver	Audit waived unless misrepresentation or fraud	N/A
Look-back	10 report years	The state can go back to date of formation or incorporation at their discretion, but may limit period to shorter time frame administratively
Who Conducts Review	Self review	Third party audit firm
Venue	Arkansas Unclaimed Property Division	Arkansas Unclaimed Property Division
Timeline	Less than 2 years	~ 3 to 6 years

LOUISIANA VDA PARTICULARS

Audit vs. VDA

CATEGORY	LA VDA	Audit
Penalty & Interest	Waived	Interest: 3 ¼ percentage points above Federal Reserve discount rate Penalty: Max \$5,000
Audit Waiver	Audit waived unless misrepresentation or fraud	N/A
Look-back	10 report years	The state can go back to date of formation or incorporation at their discretion, but may limit period to shorter time frame administratively
Who Conducts Review	Self review	Third party audit firm
Venue	Louisiana Department of Treasury	Louisiana Department of Treasury
Timeline	Less than 2 years	~ 3 to 6 years

OKLAHOMA VDA PARTICULARS

Audit vs. VDA

CATEGORY	OK VDA	Audit
Penalty & Interest	Waived	Interest: 10% of property value Failure to report/deliver: \$5,000 max Failure to pay/deliver - 25% of property value
Audit Waiver	Audit waived unless misrepresentation or fraud	N/A
Look-back	10 report years	The state can go back to date of formation or incorporation at their discretion, but may limit period to shorter time frame administratively
Who Conducts Review	Self review	Third party audit firm
Venue	Oklahoma State Treasury	Oklahoma State Treasury
Timeline	1 Year	~ 3 to 6 years

MISSISSIPPI VDA PARTICULARS

Audit vs. VDA

CATEGORY	MS VDA	Audit
Penalty & Interest	Waived	Interest: 1% of property value Failure to report/deliver: \$100 max Failure to pay/deliver - \$100 max and/or 6 month prison term
Audit Waiver	Audit waived unless misrepresentation or fraud	N/A
Look-back	10 report years	The state can go back to date of formation or incorporation at their discretion, but may limit period to shorter time frame administratively
Who Conducts Review	Self review	Third party audit firm
Venue	Mississippi Office of State Treasury	Mississippi Office of State Treasury
Timeline	1 Year	~ 3 to 6 years

QUESTIONS?

SAVE THE DATE

EVERYTHING YOU NEED TO KNOW FOR TEXAS UNCLAIMED PROPERTY PART II

MARCH 18, 2015

CONCLUSION

Thank you for your participation!

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- ▶ Unfortunately, we **cannot** currently support group CPE for International Firms. Those wanting CPE must have registered and participated from their own computer.

Please exit the course by clicking on the red “X” in the upper right corner.

SPEAKER BIOGRAPHIES

BIOGRAPHY

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With 16 years of combined experience in state and local taxation, financial statement auditing, and operational auditing, Joe has worked with a broad range of the Firms' largest clients including manufacturing, retail, distribution, financial institutions, investment companies, and business services. He specializes in state and local tax issues with an emphasis on income/franchise taxation and unclaimed property compliance and consulting.

Joe heads up the firms National Unclaimed Property practice and has had success in mitigating client escheat exposures in VDA and audit settlements before many state escheat divisions. This success is largely attributable to his deep understanding of accounting principles, transaction flow and unclaimed property law. Having evaluated financial and operational corporate risks, Joe offers clients facing escheat issues valuable accounting experience and an unique perspective in dealing with unclaimed property matters. Mr. Carr has also written various alerts and firm bulletins on unclaimed property matters, including gift card planning and strategies.

Prior to joining the Chicago office of BDO USA, LLP, Joe worked with KPMG LLP and Deloitte & Touche LLP in state and local tax and audit divisions respectively. In addition, Joe also managed the Internal Audit Division of a middle market food cooperative.

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Ricardo has over 10 years of experience advising multinational and domestic companies on unclaimed property matters. Ricardo has provided clients with unclaimed property general consulting, audit defense, and compliance services in many industries including healthcare, manufacturing, entertainment, and retail.

As the firm's West Coast Unclaimed Property Practice Leader, Ricardo has established professional relationships with many of the state unclaimed property administrators in handling client matters, and has successfully negotiated voluntary disclosure agreements on behalf of clients and provided audit representation services.

In addition, Ricardo has significant escheat planning experience and has helped many clients mitigate exposures through intercompany planning techniques and strategies.

Prior to joining BDO, Ricardo worked with Ryan, Inc. and True Partners Consulting in their unclaimed property consulting practice.

BIOGRAPHY

Gene Heatly, CPA



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Gene has over 25 years of experience in advising multistate companies on a wide variety of state and local tax matters. Gene has provided clients with unclaimed property general consulting and audit defense in many industries including oil & gas, manufacturing, restaurant and retail.

Gene has assisted in the successful negotiation of voluntary disclosure agreements on behalf of clients and provided audit representation services. In addition, Gene has significant escheat planning experience and has helped clients mitigate exposures through intercompany planning techniques and strategies.

Prior to joining BDO, Gene was with a Big Four accounting firm for 13 years and also spent 6 years in industry.

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Augusto comes to BDO with 8 years of experience advising multinational and domestic companies on unclaimed property matters. Augusto has provided clients with unclaimed property general consulting, audit defense, and compliance services in many industries including healthcare, manufacturing, entertainment, and retail.

Augusto has assisted in the successful negotiation of voluntary disclosure agreements on behalf of clients and provided audit representation services. In addition, Augusto has significant escheat planning experience and has helped many clients mitigate exposures through intercompany planning techniques and strategies.

Prior to joining BDO, Augusto worked with PwC and Ryan, Inc. in their unclaimed property consulting practice.

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