Analyzing the Custodial Account for Shippers' Proceeds

A custodial account is a trust account that is held by a market to benefit livestock consignors. Funds collected from buyers in payment of livestock sold on consignment are deposited into the custodial account and held by the market on the consignor's behalf. To ensure that the bank recognizes its trust nature, the account must be properly designated. During each custodial account review, an investigator should review the bank statements, deposit slips, and checks to verify that they are correctly designated as "Custodial Account for Shippers' Proceeds." Furthermore, the statements should be reviewed to ensure that the account is maintained in a Federal Deposit Insurance Corporation (FDIC) insured bank which protects each consignor up to the FDIC limit, in case of a bank failure. Credit Union accounts are not insured by the FDIC.

Since the money in the custodial account belongs to the consignors, the market has a fiduciary duty to maintain adequate funds in the custodial account. A custodial account review is designed to ensure that the accounts total debits, or funds available, meets or exceeds the total credits, or payment obligations. The following is the calculation used to determine whether the account has an overage or a shortage:

Calculate Total Debits

Bank Balance as of Analysis Date
+ Deposits in Transit
+ CDs and Savings Accounts
+ Proceeds on Hand
+ Proceeds Receivable
= Total Debits

Calculate Total Credits

Outstanding Checks
+ Proceeds Due Consignors
+ Expense Items Remaining in the Account
= Total Credits

Total Debits - Total Credits = Custodial Account Overage (Shortage)

Prior to conducting a review, the investigator should perform a thorough review of the market agency's records to determine prior history (size, date of last review, results of last review, Notices of Violations). Once onsite, the investigator must assess the accuracy of the market agency's records and the volume to determine the audit process. The investigator must use professional judgment to decide if market agency's records will be reconstructed to perform a custodial anlysis or if the records will be tested using samples to verify the accuracy of the custodial analysis completed by the market agency.

<u>Bank Balance as of Analysis Date</u>

For the analysis, the custodial account balance as of the bank statement date is chosen as the starting balance; however, if a potential shortage is identified an alternative date may be used. For example, an analysis date:

- One day after sale will show if the firm was reimbursing the custodial account for owners, officers, employees, market agency, and/or credit purchases;

- On sale day will show if the custodial account has been reimbursed by the close of the seventh day for uncollected funds;
- On date of misuse will determine if misuse caused a shortage; and
- As of the date of the review will give the current analysis of the custodial account.

The investigator should use their own judgment as to which date is appropriate for their review.

Deposits in Transit

Deposits in transit are deposits made by the auction market on or before the analysis date that have not yet been recorded by the bank. The investigator will determine deposits in transit while determining proceeds receivable. Specifically, buyer invoices and related documentation should be reviewed to determine funds that were collected close to the analysis date. The deposit slips and bank statement are then reviewed to identify deposits of these funds that were prepared by the market prior to the analysis date, but recorded by the bank after the analysis date.

Certificates of Deposit and Savings Accounts

Custodial account funds may be invested in Certificates of Deposit (CDs) and/or maintained in interest bearing savings accounts, provided the market's ability to meet its obligations to its consignors is not impaired. To determine the CDs and Savings Accounts, obtain a copy of the bank statement to verify the balance. The bank statements also need to be reviewed to verify that the accounts are maintained in a FDIC-insured bank and are appropriately designated "Custodial Account for Shippers' Proceeds."

The investigator needs to keep in mind that any type of investment in which there is a risk of loss of principal is not allowed. For example, Sweep and Repo accounts are higher-yielding investments where balances above a specified amount are transferred overnight into a money market mutual fund or repurchase agreement. The next banking day, the customer's funds, plus interest, are recredited to the deposit account. One problem with these types of accounts is that they are not FDIC-insured. Also, the transfer of the funds into an account that is not properly designated as a "Custodial Account for Shippers' Proceeds", risks the loss of their trust nature. Some markets may refer to a custodial zero balance checking account, which is funded by a custodial savings account, as a sweep account; however, since the funds are still maintained in a properly designated and insured account, zero balance accounts are allowed.

Proceeds on Hand

Proceeds on hand are cash and checks received from the buyers of consigned livestock that the market had not deposited as of the analysis date and differ from deposits in transit because a deposit slip had not been completed. If the analysis date is the same date as the review is being conducted, proceeds on hand is easily identified by summing the cash and checks that are at market at the time. However, if the analysis is conducted as of another date, the bank statement date, for instance, proceeds on hand may be identified by taking a statement from the office manager regarding the cash on hand and/or a person that makes the deposits and identifying that a deposit was made on the next business day. The investigator will have to make a judgment call in determination of what should be included in proceeds on hand. Generally, a significant portion of the funds in question are considered proceeds receivable and is not an issue whether they are recognized as on hand or as a receivable.

<u>Proceeds Receivable</u>

Proceeds receivable are uncollected receivables less than seven days old as of the analysis date and current date receivables due from the market, owners, officers, employees, or those who have been extended credit. To determine proceeds receivable, an investigator would:

- Identify sale dates that occurred on and up to six days prior to the analysis date. The reason six days is used is because the market agency should make a deposit by the close of the seventh business day, which would be included in the bank balance or as a deposit in transit.
- Prepare a schedule of potential receivables from the sale dates that were identified above that includes the date of the purchase, the buyer's name, and the dollar amount of the purchase. The purchases can be identified by reviewing purchaser/buyer invoices or Summary Sales Sheets, which often list cash buyers on one sheet and credit buyers on another sheet.
- With the deposit slips, identify when the receivables were collected and enter the paid date on the schedule. Proceeds receivable would be the receivables that have been identified that had not been collected by the analysis date. However, receivables from the market, owners, officers, employees, or those who have been extended credit, would be considered proceeds only if the sale date was the same day as the analysis date.

Receivables due from the market, owners, officers, employees, or those who have been extended credit that are one day or older and uncollected receivables that are seven days or older are considered <u>Accounts Receivable</u>. The custodial account must be reimbursed by the close of the next business day for purchases made by the market, owners, officers, employees or those who have been extended credit by the close of the next business day and in full within 7 days after the sale day whether or not the proceeds receivables have been collected.

<u>Outstanding Checks</u>

Outstanding checks are checks that have been issued by the market but have not cleared the bank. To determine the outstanding checks:

- Obtain the market's outstanding checklist prepared at a reconciliation date one to three months prior to the analysis date.
- Determine the first and last check issued during the period analyzed. To do this, review the last couple of checks that would have been included in the market's

analysis and determine the checks that had cleared or are listed on the outstanding checklist then review the first couple of checks issued after the analysis date. The check numbers between and including the first and last check issued will be the checks issued during the period analyzed.

- Make a list of all possible outstanding checks by adding the checks issued during the period analyzed to the market's outstanding checklist.
- Review the bank statements to identify checks that have cleared by making a tick mark on the schedule beside the check numbers that have cleared. This may be done by viewing the list of checks on the statement, the image copy or possibly the actual cleared check.
- Identify voided checks and mark as voided beside the check number. To do this, review the original voided check, if available, if not, look at the duplicate check and/or check register.
- Prepare a list of check numbers and the amounts of all checks issued but not cashed. Check amounts can be identified by seller/consignor invoices and/or check registers. Also, if the analysis needs to be fully documented, enter dates and consignor names on the outstanding check list.
- Compare outstanding checklist to the market's outstanding checklist. If the lists are different, identify the differences and reconcile with bank statements and seller/consignor invoices.
- Items to be aware of when preparing an outstanding check list
  - If a check clears twice it likely was either returned for signature or insufficient funds.
  - Banks sometimes are unable to read the check number and may list the check amount without the check number or may list an incorrect number.

If the analysis requires the review of more than one bank statement, the investigator may want to save the list as a different file or on a different worksheet prior to advancing to the next statement. By doing so, the investigator could back and complete another analysis on a different date, if needed.

<u>Proceeds Due Consignors</u>

Proceeds due consignors are sale proceeds that have not yet been issued to the consignors and often are deferred payments. To comply with P&S payment requirements, the market agency must receive written permission from a consignor to defer payment to a later date. However, Packers and Stockyards does not express an opinion as to whether the deferred payment meets IRS requirements.

There are two ways in which a market can defer payments. First, market agency can defer the payments through the Selling on Commission side of the business. If they defer them this way, the funds must remain in the custodial account until issued; however, they may be invested in CDs or maintained in a savings account as long as they are properly designated as custodial accounts. In this instance, to determine the proceeds due consigners the investigator would:

- Prepare a list, by sale date, of consignors for which checks have not yet been issued. Some market agencies may list deferred payments as outstanding checks until voided and reissued at the deferred payment date.
- Determine if written deferred payment agreements exist that authorize the deferred payment.

Another way that a market agency can defer payment is through the general side of the business or through another business as a dealer transaction. If the market uses this method, the business used to defer payments must be the party listed on the deferred agreement. Furthermore, the business deferring the payment would treat the transaction as a dealer purchase from the consignor and the market agency would issue a check to the business deferring the payment thereby removing the funds from the custodial account. In this instance, there would be no proceeds due to consigner for the custodial analysis. Additionally, the business deferring the payment has no restrictions on the use of deferred funds until the payment date but they must be registered and bonded as a dealer and treat the transactions as if they were purchases on the annual report volume.

Talk with your supervisor on how they believe deferred payments should be handled.

Unpaid Expense Items Remaining in the Account

Unpaid expenses remaining in the account are allowable expense items deducted from consignors' proceeds which have not yet been paid. These expenses include items such as check off fees, brand and health inspections, trucking, and meat board. To determine whether the sale expenses are being paid, review the market's sales summaries prior to the analysis date and make a list of all unpaid expenses. Do not include amount due to the market for services such as commissions and yardage.

Identifying Possible Reasons for Custodial Shortages

In addition to performing a reconciliation of the custodial account, the investigator should also review the account for possible misuse. This is particularly important when a shortage in the account has been identified so the investigator can determine causes for the shortage. Two steps that can be uses to determine the causes are to review the bank statements and accounts receivable.

Bank Statements

Two common misuses of custodial funds are the bank withdrawing funds from the account to pay for bank charges and to repay a line of credit. Over time small bank charges can create a significant shortage in the custodial account, if the account is not reimbursed by the market agency for the charges. If possible, the market agency should talk with the bank to see if all custodial account bank charges can be taken out of the general account. Most banks understand the trust nature of the account and will withdraw the bank charges from the general account; however, if the bank refuses and the market agency reimburses the account in a timely manner, these bank charges would not be considered misuse of custodial funds.

Another common misuse of custodial funds is the bank withdrawing funds to repay a line of credit. Misuse occurs when a market agency or the bank withdraws custodial account funds to repay the line of credit directly because loan repayments are not lawful deductions from the custodial account. Also, if reconciliations have not been prepared, the transfer may cause a shortage in the custodial account. A market agency may fund the custodial account with a line of credit, but may not repay the line of credit directly with custodial account funds. Typically, when a market agency deposits the line of credit funds into the custodial account they do so to reimburse the custodial account for uncollected funds. If the custodial account has been reimbursed in full, uncollected receivables can be deposited in the general account when collected.

To discover whether a market agency has used custodial funds for either of these activities, review the bank statements to identify the charges being deducted by the bank.

<u>Accounts Receivable</u>

Another possible reason for a shortage in the custodial account is the failure of the market to reimburse the account for uncollected receivables that are seven days or older and receivables one day or more if due from the market, owners, officers, employees, or those who have been extended credit. To determine whether this is the case, the investigator should review the markets accounts receivable. To start, obtain a list of accounts receivable from the market, or if not available, prepare a list by:

- Review receivables from sales records seven days or more prior to the analysis date and sales within the seven days for receivables from the market, owners, officers, employees, or those who have been extended credit.
- Receivables identified from these sales that are collected after the analysis date would be identified as accounts receivable.
- Interviewing the office manager may also help identify accounts receivable.
- Review the deposit slips and bank statements to determine whether the market transferred funds into the custodial account to cover the accounts receivable.

If the market did not reimburse the custodial account for the identified receivable, this would help explain why the account has a shortage.

Verifying Custodial Shortages

If a custodial account shortage is identified, it is recommended that a second analysis be conducted, preferably 60 days or 2 months apart. The exception to the 60 day/2 month rule would be if records were unavailable for a second anlysis 60 days or 2 months apart and a second analysis 30 days or 1 month apart noted custodial shortages in excess of the current bond maintained. The second analysis helps determine whether the shortage was a single instance or a practice.

After a second custodial analysis has been completed, a reconciliation should be prepared to determine the change between analyses dates, which is used to verify the accuracy of one's own work.

Possible reasons why custodial funds <u>DECREASE</u> between analyses dates.

- Bank Charges
- Sale did not balance
- Shortage in buyer payment
- Owner withdrawals
- Line of credit repayment
- Duplicate payment or overpayment to consignor
- Deposit item was returned
- Non-custodial disbursement; Auctioneer fees, rent, etc.
- Funds transferred to operating account over amount due to market
- Cash deposit shortage
- Bank error in coding on paid check amount

Possible reasons why custodial funds <u>INCREASE</u> between analyses dates.

- Commissions earned and not transferred
- Sale did not balance
- Market deposited additional funds in the account
- Deposit from line of credit
- Checks were voided without replacement with non- custodial funds
- Buyer made overpayment and then received refund from operating account
- Interest earned on account
- Deposits were made and not traced directly to any receivable
- Bank error in coding on paid check amount