

Date of Hearing: April 29, 2021

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

AB 1172 (O'Donnell) – As Amended April 8, 2021

SUBJECT: Escrow agents: asset and accounting requirements

SUMMARY: Exempts, under certain conditions, escrow agent licensees from provisions of Financial Accounting Standards Board's (FASB's) accounting standards related to lease accounting requirements. Specifically, **this bill:**

- 1) Requires the commissioner of the Department of Financial Protection and Innovation (DFPI) to exempt an escrow agent licensee from the provisions of FASB's Accounting Standards Update 016-92, Leases (Topic 842), relating to lease accounting requirements, if the licensee submits to the commissioner audited financial statements covering the current and preceding year. The audited financial statements must meet the following requirements:
 - a) They are submitted within 105 days after the close of each respective calendar or fiscal year, as applicable.
 - b) They are materially designated as qualified, as defined, by an independent accountant or third-party contractor and are completed in compliance with generally accepted accounting principles.
- 2) Deletes an obsolete provision of law applicable to escrow agents licensed prior to January 1, 1986.

EXISTING STATE LAW:

- 1) Provides for the Escrow Law (Financial Code Section 17000 et seq.), administered by DFPI.
- 2) Prohibits a person from engaging in business as an escrow agent in California except by means of a corporation duly organized for that purpose, licensed by DFPI as an escrow agent (Financial Code Section 17200).
- 3) Requires an escrow agent licensed under the Escrow Law to maintain a tangible net worth of \$50,000, including liquid assets of at least \$25,000 in excess of current liabilities. Provides that DFPI may determine, by rule, which assets constitute liquid assets and may also determine in an individual case by a specific written ruling whether a particular asset is a liquid asset (Financial Code Section 17210).
- 4) Requires each licensee to submit an audit report containing audited financial statements. These reports and financial statements must include at least a balance sheet and a statement of income for the year ended on the balance sheet date together with other relevant information as the commissioner may require. They must be prepared in accordance with generally accepted accounting principles, and must be accompanied by a report, certificate, or opinion of, an independent certified public accountant or independent public accountant. The audits must be conducted in accordance with generally accepted auditing standards and the rules of the commissioner (Financial Code Section 17406).

FISCAL EFFECT: Unknown. This bill is keyed fiscal by Legislative Counsel.

COMMENTS:

1) PURPOSE

According to the author:

This bill is critical and essential. It acts to achieve greater compliance and transparency throughout the independent escrow industry. While also addressing and providing resolution to the requirement that obliges all licensees to "double reserve" all liquid assets associated with leasehold in order to meet the current years lease obligation. This bill acts to provide greater safeguards for compliance and furnishes essential relief to any licensee potentially adversely affected by the new lease accounting standard.

2) BACKGROUND

The FASB is an independent, nonprofit organization that establishes financial accounting and reporting standards for public and private companies and nonprofits. Both the federal and state government recognize FASB as the designated standard setter for public companies, and regulators often use FASB standards when establishing standards around the financial health of licensed industries.

In 2016, the FASB and the International Accounting Standard Board (IASB) adopted guidelines to revise lease accounting standards. These revisions, part of long-term changes as resulting from the Enron accounting scandal, were meant to address concerns that companies were able to structure their lease obligations in such a way to keep certain liabilities off their balance sheets, which meant that investors and regulators lacked critical information on a company's finances.¹ As FASB explains in its own documentation, "previous lease accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions."²

These new accounting standards took effect in fiscal years beginning after December 15, 2019. As a result, a licensed escrow company must now include lease payments due within the next 12 months as part of its calculation of "current liabilities." As noted in Existing Law #3, an escrow licensee must maintain liquid assets of at least \$25,000 more than current liabilities, which means one practical impact of the new FASB standards is to require them to increase their liquid assets considerably so that the \$25,000 net difference can be maintained.

3) THE ROLE OF DFPI

Importantly, nothing in Escrow Law requires DFPI to utilize FASB standards or prevents the department from modifying what must be included in the calculation of "current liabilities" as part of the licensure requirement.

¹ <https://www.nytimes.com/2016/02/26/business/dealbook/accounting-of-company-leases-required-by-new-rule.html>

² https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010

However, DFPI thus far has shown little interest in changing these requirements. In response to the escrow industry's 2017 petition asking for a reprieve, DFPI, then called the Department of Business Oversight (DBO), responded:

DBO is concerned that excluding all leases for the purpose of determining liquidity would provide an incomplete view of a company's viability. DBO believes that the liquidity requirement is intended to be a sound measurement of a licensee's ability to meet its short-term financial obligations. If a licensee's lease obligations are excluded from its "liquid assets," the resulting amount will not provide DBO a good assessment of whether or not a company is financially sound.

4) RECENT EFFORTS

This bill is a follow-up to AB 412 (Quirk-Silver), of the 2019-2020 Legislative Session, which would have similarly excluded operating lease obligations from an escrow company's balance sheets. AB 412 was similar to AB 295 (Daly), which provided for a similar exemption but for underwritten title companies. Both bills were vetoed by the Governor, whose veto message stated:

[This] bill would allow for the exclusion of operating lease obligations from the balance sheets of escrow companies...when calculating financial liquidity requirements.

These exemptions deviate from the new standards adopted by the Financial Accounting Standards Board. These standards were created to measure a company's ability to meet its short-term financial obligations, which in turn helps protect consumer funds.

For standards to be standard, they need to apply equally to everyone. When a customer works with an escrow or title company, it is often when they are making one of the biggest financial transactions of their lives. The consequences of insolvency could jeopardize a home or business purchase and cost consumers thousands of dollars.

For the health of the industry and protection of consumers' hard earned savings, these companies should adhere to the new national standards published in 2016, which provided years to plan for compliance.

5) DESIGNATED AS QUALIFIED

This bill allows escrow licensees to be exempt from the above-described standards if they meet certain criteria related to audited financial statement. They must have submitted two years' worth of these statements and these statements must be "materially designated as qualified" by an independent accountant or third-party contractor and must be completed in compliance with generally accepted accounting principles.

Under Generally Accepted Accounting Principles (GAAP), auditors can provide an opinion that reflects the accuracy and integrity of the financial statements under review. An auditor issues an unqualified opinion if the financial statements are free from misstatements or errors; a qualified opinion means there are technical errors or mistakes that are not pervasive; an adverse opinion means that the financial statements are misrepresented or are inaccurate.

This bill only requires an auditor to issue a qualified opinion in order for a licensee to be eligible for the proposed exemption. This may be a drafting error, and it is assumed the author intends for the threshold to be unqualified or qualified opinion since an unqualified opinion reflects better on the quality of the financial statements.

Moreover, it is unlikely the requirement that a licensee's financial statements be designated as qualified represents a meaningful threshold. Under existing law, these reports and financial statements must be provided to DFPI each year and must be "prepared in accordance with generally accepted accounting principles" and submitted along with a report or opinion from an independent public accountant.

6) PROPOSED AMENDMENTS

The committee recommends amendments to address the above-described confusion around the bill's requirements that financial statements being designated as qualified. The committee suggests that the bill instead directly reference the existing accounting and auditing standards for the financial documents that escrow licensees must provide DFPI each year, as defined out in Financial Code Section 17406.

These amendments provide more clarity around the bill's proposed FASB standards exemption, but it is unlikely that these amendments will address the Governor's stated concerns described in the veto statement for AB 412. As the bill moves forward, the author and supporters may want to consider an alternative approach, such as allowing greater time for independent escrow agents to adjust to these new FASB standards.

REGISTERED SUPPORT / OPPOSITION:

Support

Escrow Institute of California (Sponsor)

Opposition

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