

# MITIGATION NECESSARY TO PROTECT LICENSED ESCROW COMPANIES FROM THE UNINTENDED CONSEQUENCES OF THE LEASE ACCOUNTING STANDARDS CHANGE

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## ABSTRACT

Escrow companies licensed by the State of California, unlike their competitors who perform escrow services under an exemption, are required to meet state mandated minimum liquidity requirements. The liquidity amount set by the legislature has created a secure environment for the transfer of property. Changes in accounting standards, independent of California law, are going to alter how liquidity is calculated, resulting in a significantly higher cash burden on licensed escrow companies than what was intended by the legislature. This will have a disparate impact on these licensees, many of whom are small, women owned businesses. The legislature has the power to mitigate this impact with the addition of a few words in the Financial Code, thereby alleviating the unintended, negative impact of this change in accounting standards on licensees.



## WHAT IS ESCROW

In California, it is customary for the sale of real property (and some personal property) to be accomplished through the use of a neutral third party (i.e., escrow agent) who protects the interests of the parties to the sale until completion of the conditions thereof. For example, in a real estate escrow the parties put things of value into the custody of the escrow agent, such as a deed or money, until all the contractual conditions for the sale are met. The escrow holder is tasked with overseeing the transaction, from initial deposit to final funding, to

ensure a smooth and secure process for the consumer.

## REGULATION OF LICENSED ESCROW COMPANIES

Licensed escrow companies are in a unique and impactful classification of primarily small, women owned businesses that are the life blood of the California economy. This backbone is being threatened by the imposition of new accounting standards by the Financial Accounting Standards Board's ("FASB"), specifically standard ASC 842, which mandates that one year of lease obligation for most leases be put on a company's balance sheet as a current liability. This change in standards will substantially impact the liquid assets requirement for licensed escrow companies in California because these licensees are required to maintain a minimum amount of liquid assets in excess of current liabilities pursuant to California Financial Code section 17210.

The Department of Business Oversight ("DBO") regulates all financial transactions of independent escrow companies in California pursuant to the Financial Code. These laws afford enhanced scrutiny and resulting protections to the public that avail themselves of their highly sought-after services. The ASC 842 pronouncement has the stated purpose of improving the financial reporting of assets and liabilities that result from a company's leasing activities. It is important to acknowledge that the public interest is not being greater served by a shift in the way assets and liabilities are being characterized as it relates to California's licensed escrow companies. Indeed, the contrary is true. By including lease obligations in calculating the current liabilities of small escrow companies, licensees will suffer an increased burden without a commiserate increase in protections to the consumer. The current standards have successfully afforded California consumers a safe and secure venue for the transfer of property. Simply, the effect of the new lease accounting standards on the liquidity calculation will be onerous and heavy handed and, as explained more fully below, will disproportionately impact escrow

licensees compared to their competitors who perform escrow services without a license.

### **ESCROW LICENSES AND EXEMPTIONS**

The new lease accounting standards will disproportionately impact the most vulnerable, growing and important segment of the California business community – women owned small businesses. This is because many licensees fall into this category and because the Financial Code that licenses persons who perform escrow allows other non-licensees to perform escrow services under an exemption. The exemption is codified in Financial Code section 17006, and it allows escrow to be performed without a license by banks, trust companies, building and loan or savings and loan associations, insurance companies (including but not limited to title insurance), any person licensed to practice law in California, and any broker licensed by the Real Estate Commissioner. None of these licensees is burdened by the liquid assets requirement in the Financial Code, such that the negative impact on licensed escrow companies resulting from the change in accounting standards, will almost certainly drive escrows toward these non-licensees. So too, none of these other entities provide the consumer protections of annual CPA audits, regular audits by the regulator, Escrow Agents Fidelity Coverage and surety bonding, all for the protection of the public. Thus the public protections though valuable by the legislature will be stripped away as transaction move away from licensed escrow companies.

### **PROTECTING WOMEN OWNED AND EMPLOYED INDUSTRY**

There is no doubt that, without revision, the new lease accounting standards will force the shut down of a portion of the licensed escrow industry, driving that business either to their big business competitors or to their lesser regulated competitors. The result of forcing a shut down of escrow business like these is fewer business opportunities for women and even greater loss in employment. California is leading the country in women-owned businesses with 1.3 million, with Los Angeles the most of any county at 429,513. Escrow licensees are part of this calculation as the

majority of these companies are women owned. The vast majority of employees at independent escrow companies are also women.



This draconian effect of the newly imposed standard makes no consideration for the successful track records of the licensed escrow community as a safe and secure resource for the transfer of property in California. The Financial Code's liquid assets requirements, which were based upon a financial standard that did not include leases as a liability, have successfully struck a balance between consumer protection and opportunity for smart, driven women to own a piece of the American dream. It is unreasonable and unwarranted for such a change to be allowed to occur and override the intent of the legislature to the detriment of women.

### **THE SOLUTION; A MINOR CHANGE TO THE FINANCIAL CODE**

The good news is that a minor change in the Financial Code can wipe away the problem and maintain the original intent of the legislature as it relates to the liquid assets requirements of a licensed escrow company. By simply adding the following language, to Financial Code section 17210, the current standard will be maintained: (e) The term "current liabilities" as used in Section 17210 of the Financial Code shall not include lease obligations.

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