



[regulations@dfpi.ca.gov](mailto:regulations@dfpi.ca.gov)

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**RE: Proposed Draft Amendments to California Code of Regulation, Title 10, Chapter 3, Subchapter 9, Article 4, Section 1741.5**

I have reviewed the updated proposed draft of Section 1741.5 which specifies the requirements pertaining to the Annual Audit Report prepared by CPAs related to the California independent escrow industry.

This draft comes after three earlier drafts from the Department of Financial Protection and Innovation (DFPI) (previously the Department of Business Oversight and the Department of Corporations) with comment periods ended October 12, 2015, October 23, 2017 and February 19, 2021.

The CALCPA Accounting Principles and Assurance Committee has also made comments dated May 6, 2013, December 8, 2014 and October 8, 2015 about the controversy surrounding 1741.5 and earlier proposed draft amendments. The American Institute of CPAs also weighed in on the controversy in their correspondence dated June 14, 2013 (Charles E. Landes, CPA, AICPA Vice President Professional Standards Team). It should be noted that the opinions coming from the CALCPA Accounting Principles and Assurance Committee is composed of some of the best and brightest CPAs who specialize in the interpretation of the CPA professional standards and have participated in the writing and redrafting of our professional standards over the years. They arrive at their opinions through an exhaustive process that involves the collaborative efforts of many CPAs. This is the type of process that should be used by the DFPI in writing any rule involving an Agreed-upon procedures engagement to be performed by CPAs.

I have also made numerous written comments to the proposed rulemaking over the last 8 years including my three most recent written comments dated September 30, 2015, October 23, 2017 and January 25, 2021 (copy enclosed for reference).

I am encouraged that the DFPI has decided that its needs and objectives can be accomplished with an Agreed-upon procedures (AUP) engagement supplementing the financial statement audit and that the DFPI in the proposed draft has attempted to incorporate the requirements of an Agreed-upon procedures engagement in AT-C Section 215 (CPA professional standard).

Some of the procedures contained in the proposed rule are well developed. However, there are some procedures that are subjective, lack clarity and do not meet the criteria for an Agreed-upon procedures engagement. Under an Agreed-upon procedures engagement, the CPA Practitioner determines that the procedures can be performed and reported on in accordance with the specified CPA Professional Standard. The DFPI wants procedures to be applied to the licensee's trust accounting records and trust bank records that are expected to result in reasonably consistent reporting regardless of the CPA performing the procedures.

CERTIFIED PUBLIC ACCOUNTANTS

1 Orchard Road, Suite 215, Lake Forest, CA 92630

T 949.465.9981 F 949.465.9985 E [patrick@feldecpa.biz](mailto:patrick@feldecpa.biz) E [brandon@feldecpa.biz](mailto:brandon@feldecpa.biz)

A CPA Practitioner cannot perform procedures that are open to varying interpretations. Terms of uncertain meaning (such as general review, limited review, check or test) should not be used in describing the procedures unless such terms are further defined within the Agreed-upon procedures engagement. The procedures should not be vague, broad, subjective and open to interpretation.

To avoid vague or ambiguous language, the procedures to be performed are characterized by the action to be taken at a level of specificity sufficient for the reader to understand the nature and extent of the procedures performed. Examples of acceptable descriptions of actions are the following:

- **Inspect**
- **Confirm**
- **Compare**
- **Agree**
- **Trace**
- **Inquire**
- **Recalculate**
- **Observe**
- **Mathematically check**

The following actions generally are not acceptable because they are not sufficiently precise or have an uncertain meaning:

- **Note**
- **Review**
- **General Review**
- **Limited Review**
- **Evaluate**
- **Analyze**
- **Check**
- **Test**
- **Interpret**
- **Verify**
- **Examine**

The above actions are too broad and vague to provide guidance to the CPA Practitioner unless the actions are articulated further as part of the procedure.

An example in the Proposed Rule that is not an appropriate procedure:

### **Proposed 1741.5.1(c)(3)(B) Dormant Trust Account**

This proposed rule wants the CPA to confirm that the following conditions do not exist when there is a Dormant Trust Account. Dormant Trust Account is defined in the proposed rule:

- Disbursement of funds were not in accordance with escrow instructions.
- Supporting documentation contains a misstatement or fails to state a material fact necessary to establish that the disbursement was for an authorized reason
- Financial institution entry lacks supporting documentation
- The supporting documentation from the escrow file has one or more characteristics that suggests possible theft or fraud.

The procedure then goes into the detail as to what some of the characteristics of fraud might look like such as:

- Invoice from a fictitious vendor
- Use of a mail drop address
- Address associated with an employee or vendor
- Internal transaction
- Transfer to an external account whose ownership cannot be confirmed
- Supporting documentation that does not relate to the underlying escrow transaction.

This procedure is doomed from the start! The procedure is asking for the CPA to confirm that certain conditions do not exist. **CONDITIONS?** That is a broad and vague word! The procedure is vague, not clearly articulated and open to interpretation. “Misstatement or fails to state a material fact...” is ambiguous and subject to interpretation. What is a misstatement in supporting documentation? What is a failed stated material fact in supporting documentation? The procedure wants the CPA to look for the “characteristics of fraud?” The characteristics of fraud have never been specifically defined. Yes, all of us, CPAs and non-CPAs have our own list or idea of what the characteristics or evidence of fraud might look like. The proposed rule gives some examples, but this is not an all-inclusive list as the DFPI implicitly acknowledges that they could not develop a complete list and have included language in the rule that the characteristics of fraud are “not limited to” the examples provided. The CPA profession has never developed a specific list of these characteristics because it is practically impossible to do so. How is the CPA supposed to identify that an invoice is from a fictitious vendor? This could be an Agreed-upon procedures engagement on its own involving hundreds of hours searching for fictitious vendors. The CPA might get lucky if it is obvious, which it never is. How is the CPA supposed to identify the use of a mail drop address? As part of the procedure, the CPA will probably have to obtain the addresses of employees and vendors the Company uses and compare addresses to those in the escrow file. This would be one of many possible procedures necessary to expose a mail drop address. Of course, the proposed rule does not explain how the CPA is supposed to identify the use of a mail drop address. The CPA might even have to do a drive by of all the addresses identified and possibly investigate further if the address is “shady looking.” A “shady looking” address is a characteristic of fraud.

The proposed rule does not adequately identify what an “internal transaction” is. Of course, the proposed rule does not address, in detail, step by step, how the CPA is supposed to determine if an “internal transaction” exists? The CPA is apparently supposed to review records and spot it! This is not a procedure or a set of procedures.

The proposed rule does not identify what a “transfer to an external account whose ownership cannot be confirmed” is. I am guessing, and I have to guess because the rule does not say it, that we will have to send out confirmations to confirm ownership of these external accounts, whatever they are. I have spent about four hours trying to understand this procedure and trying to decide how I am going to re-write this Agreed-upon procedures engagement so that it makes sense and that I can perform. This particular proposed procedure wants the CPA to find all these conditions that may not exist, does not define the conditions and does not explain in detail the steps or procedures necessary to find these conditions.

This is an example of how not to write a procedure for an Agreed-upon procedures engagement. I am surprised that the rule doesn't ask the CPA to look for the characteristics of paranormal activities. How about asking the CPA to look for the characteristics of bad fashion sense in a business office? I know at this point you are laughing (I am not!) at the last two procedures I have mentioned knowing it is ludicrous to ask anyone, including a CPA, to do that just as it is ludicrous to ask the CPA to identify the characteristics of theft or fraud.

There are other proposed procedures that are poorly written, open to interpretation, vague and lack clarity. The proposed procedures need an overhaul. I did not have time to address these other proposed procedures since the DFPI gave the industry and CPAs that service the industry insufficient time to respond. 17 Days? Serious?

An Agreed-upon procedures engagement that contains poorly developed procedures will require the CPA practitioner to modify the procedures in an attempt to meet the rule requirements and satisfy the CPA professional standards. This is what some CPAs have been doing for 19 years (since 2002). Other CPAs have blindly ignored their own professional standards and given the DFPI exactly what they wanted, substandard reporting whose opinions are worth less than the paper they are written on. Poorly developed procedures will also substantially increase the costs associated with the engagement well beyond the \$1,000 increase in costs estimated by the DFPI. I am curious how the DFPI came up with this cost estimate. CPAs will be spending a great deal of time trying to figure out and interpret the rule and underlying procedures and then rewrite the procedures so that they can be performed the Agreed-upon procedures engagement per the CPA Professional Standards. Finalizing this rule in its present state will create confusion, inconsistent reporting by CPAs, and ultimately lead to litigation when CPAs cannot perform the engagement as required by the rule. In other words, the controversy and mess will continue.

I have a suggestion. As part of the Annual Report, the DFPI receives the following client documents:

- Trust Reconciliation
- Outstanding Checks List
- Trust Trial Balance

If the DFPI wants an effective means of looking for fraud or the characteristics of fraud, the DFPI could use its own personnel and apply Benford's Law to the outstanding checks list and trial balance they receive each year. Benford's Law would expose any possible manipulation in the trust accounting. Benford's Law is not foolproof but would be a good starting point and then the DFPI could drill down from there with additional appropriate procedures if Benford's Law is not met. Our firm has applied Benford's Law to the outstanding checks list of an independent escrow company with successful results. It works! Maybe the DFPI is already applying Benford's Law during their regulatory exams? I think this is a better suggestion than asking a CPA to review hundreds of escrow files looking for the characteristics of fraud or review 50 – 100 checks looking for strange and unusual characteristics.

At the least, the DFPI should work with competent CPAs who perform Agreed-upon procedures engagements on a consistent basis to help in the writing of procedures that make sense. The DFPI has been at this for 8 years. Get some help. I would not ask CPAs who have not been performing Agreed-upon procedures since they did not recognize years ago that performing such procedures was an Agreed-upon procedures engagement and that they should not be rendering an audit opinion on such procedures. Such an opinion is worthless. We have a lot of worthless opinions sitting in public files since 2002. I understand that the DFPI is still accepting such worthless opinions as part of the Annual Reports being submitted. I am just stunned that there are CPAs out there that do not understand their own professional standards and continue such substandard reporting. The State Board of Accountancy and CPA Peer Review Program have to answer for that!

The DFPI anticipates that the typical cost for a licensee to comply with the new requirements that will require an audit of the licensee's financial statements and a separate Agreed-upon procedures engagement and report to be \$1,000 or less. For CPAs that already perform the above in keeping with their professional standards, there will be additional work, (the workload will not be the same) becoming acquainted (time incurred with interpretation of the new requirements) with the new rule, rewriting engagement letters, reworking work programs, redrafting management representation letters and redrafting the language in the AUP Reports. I estimate the additional costs for these CPAs who are already performing AUP engagements to be \$2,000 to \$3,000 since the proposed rule is not getting any better to understand after several redrafts. For CPAs that have not been performing such AUP engagements and have been performing substandard engagements in violation of the CPA professional standards, I estimate the increase in costs for these CPAs to be much higher, \$4,000 to \$5,000. I anticipate that some CPAs due to the new requirements and lack of familiarity with the CPA professional standards will discontinue performing such engagements.

The costs for performing the proposed Closing Procedures (required as part of escrow license surrender) will also be higher, especially, if the procedures lack clarity, are subjective and difficult for the CPA to interpret. Based upon the proposed procedures, I anticipate that CPAs will be designing their own procedures in order to comply with their professional standards as they have done in the past. Some of the proposed procedures for Closing Procedures lack clarity and are subjective. I also anticipate that there will be a lot of California CPAs who will decline to perform such Closing Procedures engagements due to the procedures lacking clarity, being subjective and difficult to interpret. This will make it difficult for escrow companies to surrender their escrow license.

The DFPI should also be aware that the CPA professional standards relating to Agreed-upon procedures have been updated in the last couple of years. The DFPI should review the most recent updates to determine the impact on their proposed regulation and procedures.

*Patrick D. Felde*

Felde & Company, LLP

CC: CALCPA Accounting Principles and Assurance Services Committee

Escrow Institute of California

Peer Review Committee, CALCPA

California State Board of Accountancy