

California State Controller's Office
Proposed Regulatory Action: Regulations Governing the Activities of Third-Party
Auditors Who Are Hired by the Controller
Addendum to the Initial Statement of Reasons

PURPOSE AND NECESSITY

As required by California Code of Civil Procedure § 1571(c), following a 1999 public hearing, the State Controller's Office adopted guidelines as to the policy and procedures governing the activities of third-party auditors who are hired by the Controller (the "Policies and Procedures"). These policies and procedures were enacted in 2003, and amended in 2020.²

On April 27, 2021, the Superior Court of the County of San Francisco, ruling in the case of *Yee v. Clubcorp Holdings, Inc.*, Case No. CGC-19-576314, held that despite the language of 1571(c), the California Administrative Procedures Act "applies to the Policies and Procedures." Order Re Demurrer to Petition for Writ of Mandate and Cross-Complaint (April 27, 2021), p. 6.

In order to avoid further disruption to the Controller's enforcement efforts, and to resolve any lingering questions about the validity of the Policies and Procedures, the Controller proposes to herein adopt Regulations governing the activities of third-party auditors who are hired by the Controller (the "Proposed Regulations").

FACTUAL BASIS / RATIONALE

The factual basis and rationale for each section of the proposed regulations are as follows:

§ 1180.11. Statement of Purpose

This section provides the purpose and goals of the Proposed Regulation. This section is necessary to inform the public of the general purpose of this set of regulations.

² 2003 is the earliest dated version of the Policies and Procedures the Controller has been able to identify.

§ 1180.12. Authority to Conduct Unclaimed Property Examinations

This section recites the statutory basis for retaining third-party auditors to conduct examinations of unclaimed property.

Authority: Code of Civil Procedure Section 1571(a) provides authority for the Office of the State Controller (SCO), at reasonable times and upon reasonable notice, to examine the records of any person if the Controller has reason to believe that the person is a holder who has failed to report property that should have been reported pursuant to Code of Civil Procedure Section 1500 *et seq.* Code of Civil Procedure Section 1571(c) provides authority for the Office of the State Controller to adopt guidelines as to the policies and procedures governing the activity of third-party auditors who are hired by the Controller. The four guidelines employed by the SCO often indicate a party is either lax reviewing records for unclaimed property, or has not properly set up unclaimed property review procedures, and therefore are likely to possess unclaimed property.

§ 1180.13. Adherence to contract

This section requires third-party auditors to adhere to any contract they may sign with the Controller. This section is necessary to outline the binding nature of the contract between the Controller's Office and the auditor.

§ 1180.14. Terms of Compensation

This section specifies the permissible terms of compensation for a third-party auditor. This section allows, but does not require, a third-party auditor that is employed by the Controller to be employed on a time and materials or percentage basis, or some combination thereof. This section is necessary because it offers the Controller's office the flexibility to be able to choose to offer different compensation schemes should one offer a fiscal or practical advantage.

§§ 1180.15 Principles of Examination Conducted by Third-Party Auditors

This section provides that an auditor will comply with the ten following regulations as they apply the audit process and audit work format. This section is necessary to inform auditors of the regulations that they need to follow in formatting their audit and work papers to guarantee consistency across audits.

§1180.16 Independence

This section outlines the requirement that an auditor maintain an independent mental attitude in all matters related to an examination. This section is necessary to guarantee that an audit is neutral and not effected by outside influences.

§1180.17 – Principles of Examination

This section outlines the training and experience requirement imposed on auditors. This section is necessary because the audit process is complex and requires that an auditor be trained and experienced to address any potential complications that arise during an audit.

§1180.18 – Conflicts of Interest

This Section outlines the ban on auditors engaging in work that creates a conflict of interest with the State of California. This section also outlines when such a conflict may be acceptable. This section is necessary to prevent bias or the appearance of bias in the audit process. The exemption included for this section is to allow for holders to timely report property that would otherwise be reported late. This is a common practice that prevents holders from incurring additional costs, and helps the state timely receive property. This exemption is included to preclude any claim that this preexisting process has become inconsistent with these regulations.

§1180.19 – Confidentiality

This section outlines the confidentiality requirement necessary for auditors to employ while engaging in an examination. This section is necessary to preserve the privacy of those parties whose information is part of an audit. The timing requirement is necessary to preserve documents for review by the Controller's Office.

§1180.20 – Communications with Holder

This section outlines the information that must be fully explained to a holder. Specifically, this section requires an explanation detailing: the purpose, scope, and objectives of the examination; the general approach and procedures of an examination; estimation techniques to be used under certain circumstances; and the holder's right to appeal. Each of these sections are necessary to guarantee that a holder is adequately informed of the audit process to meaningfully participate. Similarly, the information regarding the right to an appeal is necessary to help prevent needless litigation.

§1180.21 – Prior Written Authorization

This section requires that an auditor receive written authorization from the California State Controller's Office before it can engage in an audit on the behalf of the state. This section similarly requires that this written authorization be presented to a holder that is undergoing an audit. This section is necessary to guarantee that holders are able to guarantee they are being audited by good-faith actors, and no auditor is acting outside of the authority granted by the state.

§1180.22 – Principles of Examination

This section requires authorization from the California State Controller's Office before an auditor may subcontract out any work and makes any such auditor responsible for guaranteeing that the subcontractor complies with the requirements outlined by this set of regulations. This section is necessary to guarantee that an auditor is responsible for any work done on their audit, and to allow the Controller's Office to preclude the use of any unqualified or unacceptable auditors.

§1180.23 – Preparation of Working Papers

This section requires the creation of working papers, grants access to such papers to the California State Controller's Office and the State Auditor and mandates the contents of such papers. This section is necessary to guarantee that work papers are produced during an audit and that such papers contain sufficient information for the California State Controller's Office, the Attorney General's Office and the State Auditor to be able to review the auditor's process. Similarly, this section is also necessary to guaranty that the California State Controller's Office, the Attorney General's Office and the State Auditor have rapid access to the work papers of an audit.

§1180.24 – Availability of Work Papers

This section requires an auditor to provide the holder working papers for completed audits if requested. This section is necessary to guarantee that holders are given the opportunity to review the methods and findings of an audit so they can effectively advocate on their own behalf. The SCO must be notified of any such request to prepare should a matter become potentially litigious.

§1180.25 – Retention of Working Papers

This section provides the duration of time that an auditor must maintain the working papers of an audit. This section is necessary because it forces the auditor to maintain records for as long as they are likely to be relevant in the case of an uncontested finding, or following litigation, but do not overburden the auditor with record keeping that is unlikely to be relevant in the future.

§ 1180.26. Opening Conference

This section describes the opening conference and preparation for the opening conference. This section is necessary to inform holders what they are reasonably likely to experience in the process of an audit. Similarly, it is necessary for an auditor to have the explicit authority to make changes from the original plan as outlined in the opening conference to grant the flexibility to adequately conduct an audit. The subsequent section outlines the disclosure documents that the auditor must provide. These documents are necessary to inform holders of their rights and responsibilities as outlined by these regulations and to inform them of the audit appeal process in cases of dispute.

§ 1180.27. Topics Covered in Opening Conference

This section describes the topics to be covered in the opening conference. This regulation is broken into seven subsections, which are each necessary topics to the opening conference for the following reasons:

- (a) It is necessary to identify the time period covered and the examination methods employed during an audit so a holder can raise any concerns regarding examination methods, or timeframe early in this process.
- (b) The California State Controller's Office Liaison is a necessary element to the audit opening conference to guarantee that the audit complies with the expectations and standards set out by the Controller's Office.
- (c) It is necessary to identify every third-party auditor, each auditor's representatives, employees, and agents to prevent disclosure of sensitive information to unauthorized parties.
- (d) It is necessary to explain the holder's right to appeal, and the auditor's responsibilities during any such appeal to guarantee that new auditors are informed of their rights, and to help prevent unnecessary litigation.
- (e) It is necessary to fully disclose the fee arrangement between the auditor and the State Controller's Office to provide transparency into the auditor's interests in an audit.
- (f) It is essential to explain the phases of the examination process to allow holders to better plan around the needs of the examination.
- (g) Finally, it is necessary to guarantee to inform the holder the types of information, and the format of such information so that the holder can fully comply with the type and nature of the disclosure of information that the auditor may need during the audit.

§ 1180.28. Phase I of Examination: Basic Corporate Information Gathering and Site Selection

This section describes the information gathering and site selection to be conducted during Phase I of the examination. This section addresses several broad elements, each of which is outlined and explained below:

- (1) This section outlines that this phase of the audit begins with a conference between the auditor, and the holder during which, the auditor will request basic information. This process is necessary to allow the auditor to begin exploring the holder's information to help determine the scope and nature of the audit.

- (2) The holder must respond to the data and information requests within 30 days, or another agreed upon time period because 30 days is normally long enough to review documentation and present it to the auditor, and allowing the parties to agree to a different timeframe if the auditor agrees that an extension is justified provides necessary flexibility.
- (3) In the case that a holder has insufficient, or possibly inaccurate records, the audit process may use a sampling and extrapolation method of review after the Controller's Office grants approval. This section is necessary because it grants the Controller's Office the flexibility to move forward with an audit in whatever manner best uses the resources available for a specific audit.
- (4) In the case of sampling and extrapolation an auditor shall advise the holder of sampling techniques and the two parties shall come to an agreement as to the integrity of these techniques. Any failure to come to such an agreement does not halt the examination, and the auditor will inform the holder that liability determined in this way represents a fair estimation. This section is necessary because it allows auditors to use a holder's knowledge to help determine the best means of sampling and extrapolation for an audit, but also prevents a disagreement from derailing an audit. Finally, this section is necessary to inform holders of the nature of findings under these circumstances so that they can better determine a course of action.

§ 1180.29. Phase II of Examination: Devising the Examination Program

This section describes the objectives of and information gathering to be conducted during Phase II of the examination. This section is necessary to inform holders how they can expect an audit to be conducted through phase II. This section outlines several objectives and procedures which are described and explained below.

- 1) It is necessary to identify the accounts that contain abandoned property within the examination period so auditors can better determine the cause of any failure to report and find additional properties that may have escheated to the state.
- 2) It is necessary for the auditor to determine the holder's policies and procedures relating to accounting and reporting unclaimed property to find additional escheated property, and to inform the holder so it can accurately report properties in the future.
- 3) It is necessary for the auditor to determine the liability related to outstanding and stale dated accounts in the presently maintained accounting system to guarantee that as much outstanding unclaimed property as possible is captured in the examination process.
- 4) It is necessary to commence this phase with a written data and information request to keep a record of the information sought through this process.
- 5) It is necessary that auditors have the flexibility to request that data and information be produced electronically to save on the cost and time associated with hard copies of records that are more readily available in electronic format.
- 6) The final sentence of this regulation is necessary because sixty days is typically sufficient

for a holder to fully respond to an auditor's request, but including the language extending the timeframe if agreed to otherwise provides the auditor necessary flexibility in atypical circumstances.

§ 1180.30. Phase III of Examination: Examination of Accounts

This section describes the information gathering and site selection to be conducted during Phase III of the examination. This section is necessary to inform holders how they can expect an audit to be conducted through phase III. This Section outlines several objectives and procedures which are described and explained below.

- 1) It is necessary for the auditor to analyze accounts and to find unclaimed property for the property to be remitted to the State of California.
- 2) It is necessary for this phase to begin with a written data and information request so the auditor can determine if a sight visit is necessary, and what needs to be reviewed during such a visit. Similarly, allowing the auditor to agree to a specific site visit with the holder grants necessary flexibility from both parties.
- 3) The requirement of having a site or virtual visit within thirty days of receipt of the above-mentioned data and information request is necessary so there is a timeline for the auditor and the holder that is sufficiently long to allow the parties to address any scheduling conflicts.
- 4) During any such visit, it is necessary for the auditor to analyze the holder's books and records to verify any information provided by the holder, to determine what properties are unclaimed, and to select the items that will be subject to testing if appropriate. This step is largely necessary for the auditor to gain understanding of the holders existing properties, and record keeping systems.
- 5) The sixty-day time period is necessary to guarantee prompt production of supporting documentation if the auditor does not agree to an extended timeline. The language allowing for an "otherwise agreed-upon time period" allows for the auditor and the holder to extend the sixty-day production deadline in cases where both parties agree it is necessary or would be beneficial to the audit process.
- 6) A follow-up site visit may be necessary depending on the documentation provided, and the discoveries made by an auditor in this phase of the audit. Allowing this to occur at an agreed upon time gives necessary flexibility to the auditor at this phase of the audit.

§ 1180.31. Phase IV of Examination: Detailed Testing Covering Entire Examination Period

This section describes the information gathering and site selection to be conducted during Phase IV of the examination. This section is necessary to inform holders how they can expect an audit to be conducted through phase IV. This Section outlines several objectives and procedures which are described and explained below.

- 1) It is necessary in this phase of the audit to determine the overall property due for the entire

period under examination so that any such property can be remitted to the state.

- 2) To supplement ordinary review procedures, the auditor may seek authorization from the California State Controller's Office to engage in sampling and extrapolation based on the holder's records.
- 3) In the cases where the full examination period cannot be fully reviewed, the auditor's determination will calculate the unclaimed property in the base period and extrapolate the amount due for other periods from such information. Finally, any property actually remitted to the state during the extrapolation period will be credited against the amount calculated due. This section is necessary to prevent holders from avoiding the responsibility to remit unclaimed property to the state by maintaining incomplete or lax records, while allowing good faith holders to avoid overpayment for previously remitted property.
- 4) This Phase begins with a discussion between the holder and the auditor to inform the holder of the nature and scope of this phase of the audit.
- 5) It is necessary for the auditor to have a mechanism for engaging in an additional site visit at this stage because the auditor may need to verify evidence and findings. This mechanism allows both parties the necessary flexibility to continue this process based around available resources.
- 6) In some cases, electronic records may be sufficient to verify evidence and findings, which this section allows. This allowance is necessary because electronically produced samples can often save time for both the holder and auditor.
- 7) Allowing for a sixty-day production period, or one set by agreement of both the auditor and the holder guarantees prompt disclosure of documentation while allowing flexibility for parties experiencing unique circumstances.
- 8) In the case of a dispute as to the sufficiency of documentation provided by the holder, the thirty-day timeline is sufficient to fully review documentation and provide any additionally requested information. The addition of the parties being able to agree to a different timeline allows for necessary flexibility in unique circumstances within an audit.
- 9) Finally, it is necessary to outline the source of various properties that were subject to review by way of affiliation with the holder in separate reports, for greater ease of review for State Controller's Office staff.

§ 1180.32. Phase V of Examination

This section describes the information gathering and site selection to be conducted during Phase V of the examination. The goal of an unclaimed property audit is to facilitate the remittance of unclaimed property. The submission of reports, (first a notice report informing the Controller of the properties subject to escheat, and then a remit report accompanying the delivery of such properties to the California State Controller's Office) and preparation of responses allows for this process to be conducted in a timely manner at this phase of the audit.

§ 1180.33. Extension of Examination Period

This section describes the circumstances under which the examination period may be extended. This section is necessary because auditors will often find failures to report property extend into years outside of the initial examination period, and need flexibility to examine those years should they determine they are relevant to the audit.

§ 1180.34. Informal Conferences During Examination

This section explains that the State Controller's Office exercises final control over an examination and that a party under examination always has the right of to confer with the State Controller during the examination. This section is necessary to prevent any confusion as to the SCO's role during an audit, and to preclude any issue should a conflict arise between an auditor's interpretation of a situation and the SCO's interpretation.

§ 1180.35. Explanation of Appeals Process

This section requires the third-party auditor to provide the holder with an explanation of the state appeals process. This section is necessary to guarantee that holders are informed of the appeals process to prevent unnecessary litigation.

§ 1180.36- Working Paper Requirements

This section requires the third-party auditor to prepare working papers and includes requirements for those working papers. This Section is necessary for to guarantee working papers remain a useful source of information even if the specific auditor employees involved in the audit process leave.

§ 1180.37 - Working Paper Requirements

This section requires the preparer and reviewer to initial and date the lead working paper and all numbered pages. This section is necessary to guarantee that subsequent reviewers of work papers are aware of the correct party to question in the case of any confusion.

§ 1180.38 – Source, Purpose, Scope, Procedure, Findings and Conclusions

This section outlines that source, purpose, scope, procedures, findings, and conclusions are normally necessary to be included on working papers when such information is required to understand the working paper, but may be absent from such work papers in cases where they aren't necessary for full comprehension, such as when documents are obtained for background information. This section is necessary to guarantee important foundational information is available on each working paper to make review easier for California State Controller's Office staff but allows auditors the flexibility to omit the inclusion of such information where it does not contribute to the full understanding of a matter.

§ 1180.39 – Indexing

This section outlines the indexing required to be used for working papers. This section is necessary because continuity of indexing methods across different audits makes review easier and faster for the California State Controller's Office staff.

§ 1180.40 – Cross-Referencing

This section outlines the cross-referencing required to be used for working papers. This section is necessary because continuity of cross-referencing methods across different audits makes review easier and faster for the California State Controller's Office staff.

§§ 1180.41 – Legends and Tick Marks

This section outlines the legend and tick mark required to be used for working papers. This section is necessary because continuity of legend and marking organization standards across different audits makes review easier and faster for the California State Controller's Office staff.

§ 1180.42. Sampling Requirements

This Section outlines the two available sampling methods and requires that any sampling comply with professional standards. This section is necessary to guarantee audits conform to modern standards and practices as these practices evolve and develop.

§ 1180.43. Cooperation Among the States

This section addresses limitations on multi-state audits and the process for resolving any conflicts that arise between states in a multi-state audit. This section is necessary to prevent any dispute arising between states should a holder become the subject audits from two or more states.

§ 1180.44. Closure

This section provides the requirements for closing an audit, including provision of an examination report. Section (a) handles several factors, all of which are necessary as explained below:

- (1) This section requires that the auditor will provide the audited holder and the SCO with a report that includes the procedures performed during the audit, the conclusions reached, and the amount deliverable. These are necessary elements for the holder because they will need to be informed of what they owe the controller and will need to determine if they seek to appeal the audit conclusion. The Controller will need this information as well because it will need to determine that a holder is meeting its obligation to remit property pursuant to a finding.
- (2) This section details that the content and format of a report will be in accordance with the following subsection. This section is necessary because the SCO reviews numerous audits in a year. Having mandated format and contents allows the SCO staff to more readily review audits and prevents miscommunication between the SCO a third-party auditor.
- (3) The following sentence reiterates that the SCO maintains final review authority over an auditor's work papers. This is necessary to guarantee that auditor's and SCO staff adequately address any confusion that may arise during an audit.
- (4) Finally, this section requires that a holder be informed of any assessment made on delinquent properties. This section is necessary because the holder will be responsible for

delivering payment of any penalty or interest due on delinquent property. A holder needs to be informed of such an assessment before they can pay it.

Section (b) addresses the contents of the report mentioned in section (a). This section is necessary to guarantee consistency across the many reports SCO staff will need to review. Each section is necessary to help California State Controller's Office staff understand the holder's situation, the information that was examined during the audit, and the ultimate finding of the third-party auditor.

§ 1180.45. Third-Party Auditor's Compliance with Regulations

This section provides that a third-party auditor's failure to comply with regulations shall not invalidate or impair an audit. This section is necessary because without it, bad-faith auditees would try to argue that an auditor failed to comply with these regulations in some minor way, and delay remittance under the pretense that an otherwise legitimate finding is unenforceable. Similarly, to preclude a holder trying to imply that these regulations are meant to give a holder any additional rights or litigious remedies that were not intended during drafting, the Controller's Office is explicitly not creating a cause of action.

§ 1180.46. Correspondence

This section provides the address and telephone number for correspondence regarding these regulations. This section is necessary because the address provided is the one already made publicly available for contacting the Controller's Office Audit Division. Providing this address prevents the Controller's Office from needing to devote additional resources to handle correspondence.

§ 1180.47. Sample Confidentiality Agreement

This section provides a form of confidentiality agreement. This section is necessary to provide auditees and third-party auditors with a sufficiently protective confidentiality agreement while allowing for an auditor and auditee to create their own agreement should one of the parties have specific concerns not addressed by the confidentiality agreement provided.

§ 1180.48. Confidentiality Agreement

This section provides that any confidentiality agreement used between the auditor and the auditee must be at least as protective of the information subject to the audit as the sample provided above. This section is necessary because it guarantees that any party that elects to use a confidentiality agreement other than the one included in section 1180.47 will maintain a similar level of confidentiality to protect the private information of the holder, and of the members of the public of California whose information included in the audit review process.

ECONOMIC IMPACT STATEMENT

Creation or Elimination of Jobs within the State of California

It is not anticipated that these regulations will create or eliminate jobs within the State of California. These regulations do not create a new process for overseeing the activities of third-party auditors in the State of California, but clarify and reenact the previous Policies and Procedures. The firms that engage in this type of business will not need to hire or fire staff to meet

any potential demand effected in the state of California.

Creation of New or Elimination of Existing Businesses within the State of California

It is not anticipated that these regulations will create or eliminate existing businesses within the State of California. These regulations do not create a new process for overseeing the activities of third-party auditors in the State of California, but clarify and reenact the previous Policies and Procedures. The firms that engage in this type of business will not need to close, and new firms will not be incentivized to open to meet any potential demand effected in the state of California.

Expansion of Businesses or Elimination of Existing Businesses within the State of California

It is not anticipated that these regulations will expand businesses or eliminate existing businesses within the State of California. These regulations do not create a new process for overseeing the activities of third-party auditors in the State of California, but clarify and reenact the previous Policies and Procedures. The firms that engage in this type of business will not need to close, or incentivized to expand to meet any potential demand effected in the state of California.

Benefits of the Regulations

The State Controller's Office has, for a number of years, relied on third-party auditors to conduct unclaimed property audits for the Controller. The use of third-party auditors has provided a number of benefits to the residents of California, and the State Controller's Office uses third-party auditors to locate, identify, and collect unclaimed property. For example, the Controller, working with the assistance of third-party auditors, led a national team that restored approximately \$2.4 billion in life insurance benefits nationally, and more than \$300 million to Californians. See https://www.sco.ca.gov/eo_pressrel_17198.html. However, as reported in a recent report by the Legislative Analyst's Office, only approximately 2% of California businesses file unclaimed property reports annually. See <https://lao.ca.gov/Publications/Report/3978>. The use of third-party auditors is one way for the Controller to increase compliance with the unclaimed property law.

Continued use of third-party auditors, as proposed in the Proposed Regulations, will allow the Controller to continue to locate, identify, and collect unclaimed property.

For these reasons the State Controller's Office believes that the proposed regulations will not benefit the health and welfare of California residents, worker safety, or the state's environment.

Unless otherwise specifically noted, the Proposed Regulations are closely analogous to the Policies and Procedures.

The SCO does not believe that these regulations will have a significant economic impact on the state of California, as the firms that are engaged as third-party auditors already exist, and these regulations will not have an impact on the demand for these services.

REASONABLE ALTERNATIVES

The only alternative considered was to leave existing regulations unchanged, or to pursue further legal action regarding the validity of the Policies and Procedures as originally adopted. However, questions about the clarity and enforceability of the Policies and Procedures indicated that adopting the Proposed Regulations was preferable.

Moreover, due to the volume of unclaimed property audits conducted by the State Controller's Office, it is not feasible for the Office to conduct all audits using the Controller's in-house audit personnel. Relying solely on the Controller's Office's auditors is not a reasonable alternative. Accordingly, it is necessary for the Controller to employ third-party auditors to assist the Controller with undertaking unclaimed property audits.

In addition, the Controller often joins multi-state audits of entities whose records and data are stored out of state, rendering third-party auditors best suited to conduct such audits outside of the State.

Finally, California represents approximately ten (10) percent of the population in the United States. Given its significant size, it would be impracticable for the Controller's in-house audit teams to conduct all unclaimed property audits internally. The Controller's audit staff necessarily relies on third-party auditors due to the volume and scope of the State's unclaimed property audits.