

RECORDKEEPING AND TRUST ACCOUNTS

(8.0 Credit Hours)

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RECORDKEEPING AND TRUST ACCOUNTS

(8.0 Credit Hours)

PART ONE - OVERVIEW

INTRODUCTION

This chapter presents the general concepts and guidelines necessary to establish and maintain all escrow accounting records. Regulations governing these operations are found in C.R.S. 12-61-102, 103(7), (8), 113(1), (Chapter 14), Rules E-1 through E-5, E-21, E-29 through E-32, (Chapter 15) and the subdivision references cited in Part 4 of this chapter. Answers to frequently asked questions are found in Chapter 16. Other laws related to real estate practice and property management are presented in Chapters 6 (Fair Housing), 11 (Property Management), and 17 (Related Real Estate Law). Important information about industry developments, legislation or changes in regulations is published quarterly in the "Colorado Real Estate News." Licensing information, applications, and past newsletters are published at:

<https://www.colorado.gov/dora/division-real-estate>

(The site also publishes key contract forms, the licensing statutes and Rules of the R/E Commission. As of the date of your enrollment, however, you have the most up-to-date forms, Rules and License Laws available – and will likely be more current than those on the Commission website.)

New brokers may obtain startup information from the Small Business Development Center, 303-592-5920, or 1-800-333-7798, or access the following link:

<http://www.coloradosbdc.org/starting-your-business>

Brokers also may request an examination of any proposed escrow accounting system by calling 303-894-2316 or faxing a request for assistance to 303-894-2683, attention: Chief Financial Examiner, Auditing Section.

CONCEPTS AND RESPONSIBILITIES – A CHAPTER SUMMARY

The "Escrow Accounting Equation" is the cornerstone for all related accounting processes. It states that at any given point in time the reconciled escrow bank account cash balance must equal the corresponding escrow account liabilities per contract.

When the employing broker receives any "money belonging to others," five obligations are generally undertaken: (1) the broker receives custody of the escrow cash asset as a "fiduciary" or "trustee" for another, rather than as its legal owner; (2) the broker agrees to perform various duties for another, who is termed a "beneficiary" in the Commission regulations; (3) the custody, control, ownership

and use of each escrow asset is governed by the underlying contractual agreement, any applicable regulation or other superseding law; (4) the broker is required to deposit and account for these assets in a prescribed manner; and, (5) the broker remains responsible for the outcome of these acts when others perform them on his/her behalf.

Escrow bank accounts are unique "accounting entities," which are separate in purpose and function from the other accounts commonly used in a real estate business. "Escrow" and "Trust" are synonymous descriptive terms for the broker's fiduciary account in all Commission regulations. This type of account excludes money handled for on-going personal business income, expenses, commissions, and/or other non-licensed business transactions. Funds belonging to the same "common class" of beneficiaries are normally deposited into a "pooled" escrow bank account, unless otherwise prohibited by other law or agreement between the parties concerned. In other cases, the broker may choose to open a separate escrow bank account for funds held in each separate engagement. This structure is frequently found in the sale of luxury homes, where large earnest money deposits are held in separate interest bearing accounts, or when the company manages broker owned properties, or for other significant accounting entities are managed by the broker. The use of separate trust accounts for each significant entity provides greater protection against possible "illegal commingling of funds" described below. Diagrams showing the typical flow of funds and common company bank account structures for sales and management companies are found later in this chapter.

The general concepts and responsibilities for maintaining escrow accounts apply to all types of real estate accounting activity. Common functional activities include establishing and maintaining bank accounts, collecting, evaluating and recording accounting information, maintaining transaction files, reconciling accounts with related real estate business records and documents, reporting accounting activity to interested parties, training and supervising staff, and storing records for later use.

Each escrow bank account must have a corresponding set of office accounting records. These may be kept manually or by use of a computer. The terms for the required records are: a "journal," the individual "beneficiary ledgers," the "broker's ledger," the "monthly bank reconciliation worksheet," and the related "property transaction files." Sample accounting records and transactions are illustrated in Section (4); blank forms are found in the chapter Appendix. These forms may be modified within the constraints of Rule E-1 (p) to suit business needs.

The bank reconciliation process used for maintaining escrow accounts differs in a significant way from other methods used to reconcile personal or other business accounts. The goal of this process is to insure proper records have been established for actual events, and to verify the information recorded in the office

records agrees with the activity shown on the monthly bank statement. This requires examining certain financial provisions found in the pending sales contracts, leases, management agreements and related business records and recording the financial data in the corresponding escrow account journal and ledgers. The total resulting "contractual liability" is then reconciled to the escrow bank account cash balance at a given point in time. The results are summarized on a form called the "bank reconciliation worksheet." Absent missing documents, unintentional errors or internal fraud, this "worksheet" is a snapshot of the overall condition of the escrow accounting equation. If the worksheet was properly prepared and balances, it indicates that all escrow liabilities are fully funded, and all financial obligations are properly reported in both the accounting and banking records. When the worksheet doesn't balance, the cause may be due to more serious conditions described next.

In order to avoid "illegal commingling of funds," (See Rule E-1(e), Chapter 15) proper control over paying expenses must be maintained on a day-to-day basis; this means: never overspend or misuse any beneficiary's available cash balance. Such misuse is described as "converting" (stealing) and/or "diverting" (borrowing or loaning) money without authorization. These practices endanger the public interest by removing the beneficiary's property from the account without settling the corresponding contractual liability as agreed; the resulting cash shortage will mean that in the event of any unexpected termination of business after the misuse, some liabilities can not be paid from the available escrow account cash balance. Other practices often accompanying this condition are: (1) "failing to deposit" funds into an authorized account, (2) "failing to account for" the activity performed, (3) "misrepresenting" the status of financial information to others, or (4) other on-going uncorrected accounting errors. The commission may impose administrative discipline in these cases and other civil or criminal statutes may also apply.

The general function of a "journal" is similar (but not necessarily equivalent) to a check register. The journal reports information about all events causing a change in the escrow bank balance over a given period of time. The function of each individual beneficiary ledger is to account for the information pertaining to all changes in the amount of cash held for a specific party during the same period of time.

Because of the possibility for internal theft, "blind trust" in the "equality" of the accounting equation will not guarantee that the intervening escrow accounting entries were properly made or represent corresponding real events! The employing broker and another officer/company owner, with assistance from an appointed and independent internal audit committee, should establish, review and perform the following critical supervisory functions on an on-going basis: (1) examine all company banking and accounting activity for proper operation, (2) review the quality of all services provided by all associates and any affiliated businesses entities, (3) maintain effective channels of communication,

community feedback and personal involvement in key operating processes, (4) enforce and promptly correct improper practices or violations of company policy, and (5) provide adequate compensation, necessary training and adequate supervision to minimize the "controllable" means, motivation and opportunity for financial harm to the public.

PART TWO – SALES ESCROW ACCOUNTS

(1) THE ESCROW BANK ACCOUNT

General Operation. The Federal Deposit Insurance Corporation (FDIC) provides "dollar-for-dollar" insurance coverage for money held in all accounts maintained by a specific depositor-beneficiary at an insured bank up to a maximum amount of \$250,000 per person. Supplemental private deposit insurance should be considered when this amount is exceeded.

The broker's use of a non-escrow business checking account for escrow money will result in commingled ownership of these funds. The identity of the individual depositors or their personal financial interest in the total bank account balance will not be determinable from the bank's own legal records. As the result, this type of account will only qualify for \$250,000 of F.D.I.C, insurance coverage in total. In the event of a bank failure, each depositor would be reimbursed according to the percentage his or her balance constitutes to the total account balance. Any excess of funds deposited over the share of the coverage will be treated as "uninsured loss," which will be the broker's responsibility. To overcome this limitation, the bank's "customer deposit agreement" must identify the broker as a "fiduciary," and the records prescribed in Rule E-1 (p) must be kept on a day-to-day basis. If those conditions are met, then each beneficiary's coverage will be extended to full \$100,000 limit per person. The escrow account title format shown on the next page must be used to show the fiduciary nature of any real estate escrow account owned by the broker.

The employing broker, a licensed sole proprietor, the corporation, the partnership or the LLC, are the only "persons" authorized by statute to "own" and operate company escrow accounts. Licensed associates may not establish company escrow accounts in their own name. However, they may be designated as alternate signors on any escrow or company bank account, as long as the employing broker can independently operate all company owned escrow accounts. In order for the broker to delegate the authority to perform accounting duties to another, the duties must be accepted in a dated and signed job description. The associate is then primarily accountable for the outcome of the acts and duties within their control, and the employing broker will have responsibility for supervision of the duty as well.

The following diagram illustrates common alternative flows of funds through an escrow account:

Earnest Money

(Path A) Broker Transfers the Earnest Money Deposit:

- Deposit held by broker in Sales Escrow Account
- Transferred to closing entity for settlement.

OR

(Path B) Closing agent deducts Earnest Money from the commission:

- The EMD is transferred to the business account after closing

OR

- The Earnest money refunds to the Buyer /
Broker's/seller's share (forfeitures) to the Seller

How to Open Escrow Bank Accounts. Public notice of the fiduciary nature of the escrow bank account must be given by the identification shown on the bank's customer deposit agreement described in Step 2:

Step (1) Select a Colorado depository that offers F.D.I.C. insurance coverage or as authorized for the specific engagement. Information about the financial strength of various institutions may be obtained from the Weiss Research Group, (800) 289-9222.

Step (2) Include the following "fiduciary elements" in the account title. These must identify the true owner of the account, specify the type or purpose of account being established (sales, management, HOA, etc.), include one of the fiduciary words "escrow" or "trust", state the employing broker's personal name, and show his/her fiduciary capacity as "broker." The use of CARHOF accounts is found in that section on the next page. The employing broker must be able to independently control and operate all escrow bank accounts, but others may be designated as signatories as well. These elements may be abbreviated to facilitate printing the broker's monthly bank statement heading, checks and deposit stock. The general account title format follows:

- **Licensed brokerage name and/or d.b.a. (brokerage TIN/SSN)**
- **Type of escrow, broker's name, broker**
- **Statement mailing address**

Step (3) Obtain copies of the "customer deposit agreement" and "signature card(s)" and retain them with other office escrow records for later commission inspection. Update these records whenever there is a change of authorized signatories or bank ownership.

Step (4) Execute the commission "Notice of Trust or Escrow Account," shown in the Appendix, Exhibit A. This form may be typed on the broker's stationery and should be retained for later inspection.

Step (5) In order to reduce the risk of accounting error and internal theft, select (and/or design) company checking supplies that provide a clear record of individual accountability for all accounting and banking operations performed on the broker's behalf. CD-ROM imaging of banking records (and other office files) is permitted when reproductions and endorsements are easily readable with the eye and are retrievable upon reasonable request. The personal name of the employing broker acting for a corporation, partnership, or limited liability company is not required on deposit slips or check stock.

Step (6) Please note: The first line of the account heading is reserved for the legal identification and TIN/SSN of the true account owner. Never use a third party name or TIN/SSN identification number on a "company owned" account, as this practice may enable the other owner(s) to independently transact business without the broker's consent. If the account is properly owned by a third party, e.g. a homeowner's association or a commercial enterprise to be managed by the broker, and the broker is only added as another signor on the account, the fiduciary elements shown in Step (2) are not required.

All independent account signors should understand the applicability and scope of any "setoff or seizure rights" stated in the bank deposit agreement.

Other Types of Escrow Accounts. The following guidelines apply to the use of interest bearing accounts, stock market investments, CARHOF accounts for affordable housing programs, credit union accounts, and the transfer of earnest money deposits to a third party or closing entity.

Written disclosure and consent must be obtained for use of a passbook "interest-bearing account" or "certificate of deposit." This requires a description of the account used, the risks involved, any applicable restrictions or penalties, and an agreement for the ownership of any subsequent income or loss. If there is no disclosure or consent from the beneficiary, any earnings belong to the beneficiary and any loss/penalty will be the broker's responsibility. The interest earned will normally appear on the monthly bank statement, and must be recorded in the broker's journal and/or allocated to the ledger of each beneficiary-owner. Any interest contractually retained by the broker must be entered on the "broker's ledger." An IRS Form 1099-INT must be sent to the beneficiary at year-end.

The city of Boulder currently requires the payment of a statutory rate of interest to tenants residing in that jurisdiction; see Ordinance 4969 Title 12, Chapter 2. The simplest way of dealing with this matter is to not use an interest-bearing account and fund the tenant interest payment by charging the statutory amount the owner. Otherwise, the broker will have to account for and periodically allocate the differences in market and statutory rates to the owners concerned. The solution is a business policy decision that should be disclosed in the management agreement.

In general, a broker may not independently establish an escrow bank account outside Colorado, or deposit money belonging to others in a stock market or institutional "cash-asset management investment account," without the informed written consent and specific waiver of the applicable statutory requirements by those concerned. However, commission policy permits the deposit of credit card receipts into an out-of-state bank clearing account (to secure lower processing rates) if the broker's records are able to track individual transactions in and out of the clearing account by name, date, purpose and amount. In contrast, any investment made solely in the broker's name where escrow funds are pledged as collateral for brokerage credit, capital loans or as security for other institutional investments and/or debt is prohibited. Similarly, an investment of escrow funds is prohibited when federal insurance coverage only applies to the sponsoring institution or its agents for unlawful events, but fails to insure the beneficiaries on a "dollar-for-dollar" basis.

Credit Union accounts may be used for escrow funds and earnest money deposits. As of 2013, former Rule E-1(c) – which prevented use of credit union accounts unless each beneficiary is actually a member when the funds are deposited - was repealed. Currently, non-member deposits are also insured.

Participation in a CARHOF (Colorado Association of Realtors Housing Opportunity Fund) or a similar non-profit qualified community affordable housing program is voluntary. This requires posting a general public notice about the program at broker's normal place of business. No further contractual consent is required. The interest earned is transferred to the program as the interest beneficiary only (IBO), using the CARHOF program non-profit tax identification number. The term "CARHOF (IBO)" may appear on the left side of either the first or second line in the account format shown in Step 2 on the previous page, according to bank requirements. The terms "CARHOF IBO" is not printed on company check stock or deposit slips. Other company programs that are established by the broker to benefit needy employees, a class of citizens, a favorite social service, medical organization, or charity are not eligible for treatment as a "qualified community housing program." The Commissioners voted to limit such participation to non-profit real estate activities within their jurisdiction. This limitation doesn't prevent a written agreement between parties in a specific transaction to distribute interest earned to whomever they wish. Further information, applications and banning agreements for participation are available from the local board or CAR, 303-790-7099.

When a contract is amended to allow the transfer of the earnest money to a third party or "closing entity," the broker will not need to maintain the normal escrow accounting records required by Rule E-1 (p). Instead, Rule E-1 (o) requires retention of the following items in the property transaction file: (1) a signed and dated receipt from the third party designated to hold the funds, (2) a copy of the earnest money check, and (3) a copy of any endorsement needed to make this

transfer. The type of depository account used by the third party must be consistent with that provided in the approved contract form. The party (ies) concerned must approve the terms and costs of any third party "custodial/escrow agreement" used in the transaction; however, such agreements shall not "automatically nullify" the duties found in other commission-approved forms.

Special Use of Accounts. The provisions of Rules E-1 (i), E-16, and E-1 (e)(5) affect how various bank accounts may be used.

Rule E-1 (h) allows a broker to manage less than seven (7) single family residential units and/or duplexes in the sales escrow account. Any related security deposits may be also be held in this account. The opposite case applies to earnest money deposits received by a property management broker; these may be placed in the security deposit account or held intact in the owner's management escrow account with the usual accounting records.

Rule E-16 allows the liability ("financial responsibility") for the timely return of a tenant's security deposit to be transferred from the broker to the property owner when there is a consistent agreement to this effect in the management agreement/addendum, and in an accompanying notice to the tenant in the lease/addendum or by first class mail. The security deposit may then be paid directly to the property owner, held in the owner's management escrow account, or used as that owner's management operating capital. This option may not be advisable when poor business relationships exist among those concerned.

Rule E-1 (e)(5) requires use of an additional "pooled escrow account," separate from other third party client trust accounts, when the broker has an "ownership interest" in a partnership, joint venture, or syndication and receives compensation for selling or leasing such property. The broker may also choose to establish a separate escrow account for each "significant accounting entity" owned or otherwise managed and be in compliance with this and other rules. When a licensee personally receipts for security deposits in the management of his/her own property, that obligation is personal and the use of escrow accounts isn't required. An employing broker's written company policy should address an associate's responsibility to clearly differentiate and separate "personal business" from other normal company activities. Under commission case law, the licensee acting for his/her "own account" remains responsible to perform all promises made, to account for the funds received and to disclose their licensed status to others, Rule E-25.

(2)THE CASH RECEIPTS AND DISBURSEMENTS JOURNAL (the "JOURNAL")

General Concepts. The "journal" is described in Rule E-1(o)(1), and is maintained when the broker receives or is designated as custodian for any "money belonging to others," as defined in Rule E-1(f). A blank form is at Exhibit B in this course's Appendix.

The journal, the corresponding ledgers, the bank account and the related contractual liabilities are always intended to be self-balancing and equal to each other. The journal is maintained on the "cash basis" unless the beneficiaries agree to use accrual accounting. The cash basis of accounting means that receipts and payments are recorded when received for deposit or paid. The journal remains open until the corresponding bank account and open ledgers are closed.

Intentionally reporting expenses as "paid," or amounts as "received" in any escrow record or corresponding accounting or beneficiary report, without mailing the check, or making a bank deposit is a serious form of misrepresentation, failure to account and possible fraud. Similar conditions can be created by "receipting for funds" in the contract but not receiving possession of the money and depositing it in a reasonable time.

Concerns may arise as to the "validity" of an acceptance of an offer when a "faxed copy" of the earnest money check is submitted to the listing broker or designated custodian. The absence of an actual earnest money check at the time of (or one day after) the acceptance does not invalidate the contract. Other provisions will normally provide the necessary "legal consideration" to make the acceptance binding. Some financial institutions are willing to accept a fax copy of a check as the maker's authorization for transfer of funds to a designated custodial account. Brokers are advised to have prior written agreement for use of this process, verify the receipt of "good funds" by the designated custodian and to communicate the results promptly to those concerned.

The "ending journal balance" includes all money held in escrow (pending closing or final disposition) for all beneficiaries, including any unearned funds belonging or ultimately due to the broker and/or the results of other bank adjustments and service charges. The escrow cash account balance is normally shown in the current asset section of the escrow account balance sheet, while the total for the corresponding total for all pending ledgers appears in the current liability section. Changes in these balance ending sheet amounts are explained by the transactional data recorded in the cash receipts and disbursements journal during the monthly accounting period. A negative escrow bank balance, an accounts receivable, or a debit balance in the escrow accounts payable or the escrow "equity" section may be the result of error or illegal commingling of funds.

A general policy of accepting cash (legal tender) in on-going transactions is discouraged without corresponding fidelity insurance and effective internal controls. Most thefts aren't detected until the loss reaches \$20,000-\$35,000 and recovery depends on proving a person's specific responsibility for the disappearance. Certain cash sums totaling \$10,000 or more require reporting on IRS Form 8300, per Publication 1544, which is available from www.irs.ustreas.gov/prod/cover.html.

Handling Earnest Money and Making Deposits. Rules E-1 (l), (m) and (n) require the timely deposit of escrow funds and govern who is to receipt for and hold such money.

There are several accepted options for handling earnest money. These funds may be held: (1) in an account specifically identified in the sales agreement, (2) in an escrow account maintained by the buyer's agent, (3) in the listing agent's escrow account, or (4) in any other account acceptable to the buyer and seller.

The party designated to hold the deposit must be clearly identified in the sales contract. A check for the earnest money should accompany the offer until it's accepted. A buyer's agent holding the deposit may forward a copy of the earnest money check with the offer. If the offer is rejected, this broker may simply return the check to the prospect. Submitting an offer to a seller that specifies the receipt of an earnest money on its face, without actual receipt and deposit of the money in a reasonably agreed-upon time is a serious misrepresentation and may violate federal law or HUD regulation.

Unless otherwise agreed, earnest money deposits held by the designated broker shall be deposited not later than the third business day after notice of acceptance of the contract. The broker should keep a copy of the validated escrow deposit slip and earnest money check in the office transaction file for later inspection. The initial deposit slip and/or a subsequent wire transfer form to a third party or closing entity must show the buyer's name, the related property description and must be recorded in the journal and the specific beneficiary's ledger. If a promissory note is initially received as the earnest money deposit, no entry of the deposit is made until the note is redeemed. The use of a promissory note must be authorized in the contract and shall include a specific date for redemption. Timely collection of the note is essential, and notice of a failure to redeem the note on its due date must be communicated promptly to the seller. A failure to inform the seller of a default on the note may result in a complaint for misrepresenting the status of the contract.

Money received for property management and short-term rentals shall be deposited within five (5) business days after receipt unless the parties agree otherwise. All other types of money belonging to others shall be deposited not later than the third business day after receipt or as provided in the agreement with those concerned.

Earnest Money Disputes and Unclaimed Property. The broker should retain correspondence, which shows reasonable efforts were made to return refundable amounts to the proper beneficiary, or that such amounts were transferred to the appropriate state "escheat fund" for later distribution.

If the beneficiary can't be contacted and the last known address is outside Colorado, the "escheat" laws of that state should be followed. If the state has no law, then the property must be transferred to the Colorado State Treasurer's "Great Colorado Payback Fund," per C.R.S. 38-13-103. This normally occurs no later than five (5) years after abandonment.

When a party fails to cash a refund check six to twelve months after its issue, or if the broker has reason to presume the funds have been abandoned, a "stop payment" order may be issued to the bank and the amount will be added back to the journal balance. The funds are then entered on an "Unclaimed Property Ledger," and a note of this event is made on the original beneficiary's ledger to close it out and place it in the property transaction file. Any subsequent activity is reported on this continuing ledger showing the status or disposition of such property through the appropriate escheat fund. If a party later claims this amount before transfer to the escheat fund, a new check is issued and recorded in the unclaimed property ledger and the escrow account journal. A copy of the new check should also be placed in the property transaction file. Unclaimed and undisputed items may be transferred to the Colorado Fund prior to the end of the 5-year period.

If a dispute over ownership of a deposit develops, the guidelines found in the commission position statement on earnest money deposits (Chapter 16) must be followed. If a court refuses to accept custody of funds tendered, the money must be held in escrow until there is a resolution of the dispute, a release is obtained from one party, the statutory record keeping period under C.R.S. 12-61-113(1)(i) has expired, or there is good reason to believe the dispute has been abandoned. Subject to legal advice or further instructions from the parties concerned, the disputed but abandoned funds may be transferred to the escheat fund in the original depositor's name. When earnest money is held by a third-party closing entity, where return of the deposit to a buyer is not disputed and the buyer can't be located, but agreed to pay all or part of any third party escrow agreement fee, then the broker may distribute the "net amount" to the appropriate escheat fund. The commission has no guidance on making this business decision.

If the licensed real estate business is terminated before any notice of dispute is received, and the amount is abandoned, the money may be delivered to the appropriate escheat fund in the original depositor's name. Further information, other state search links, and software for reporting these items in Colorado can be obtained from Colorado Great Payback office, 303-894-2443 or: <http://www.colorado.gov/treasury/>

(3) THE BENEFICIARY'S LEDGER RECORD (the "LEDGER")

General Concepts. The "ledger record" is described in Rule E-1 (o)(2). This record separates one person's transactional activity from all other data recorded in the journal and processed through the escrow bank account. Blank forms for the beneficiary and broker's ledgers are found in Appendix, Exhibit C.

There are two types of ledgers used for normal escrow accounting functions: those for external beneficiaries assisted or represented during the engagement (the seller, buyer, a management property owner, the tenant, or unclaimed property described in the proceeding subsection), and for the internal beneficiary, the employing broker, who maintains the account and/or provides any financing services to the external beneficiaries per Rules E-1 (e)(4) and E-1 (o)(5). The "broker's ledger" record is described below. According to industry custom, the ledger maintained for each guest stay in short-term (hotel type) property management is called a "folio."

In a manual record keeping system, all pending ledgers are usually maintained in a three-ring notebook and are alphabetized by client name or by address; different buyers may have deposits on the same ledger; these should be identified as "backup offers." Closed ledgers are kept with copies of the deposit slip and earnest disbursement checks in the property transaction file. The journal pages are placed in front of the pending ledgers and broker's ledger in this notebook.

When a separate passbook savings account is maintained for each beneficiary with proper disclosure and authorization for the use of interest-bearing accounts, the monthly bank statement will satisfy the record keeping requirements for both the "journal" and a "ledger." However, the bank may charge a higher service fee for extensive use of these temporary accounts and may restrict the number of open accounts allowed to one broker at a time. This shortcut method is acceptable with maintenance of proper identification of individual parties in the deposit slips and check memo lines.

New Quicken, QuickBooks, Tenant Pro, and other computer software have journal and ledger capabilities. The responsibility for insuring compliance with commission requirements rests with the broker and not the software developer. The broker may consult with the financial examination section to insure that any proposed system will meet regulatory requirements. The cost and/or accounting skill required for proper use of software will vary according to the software program selected. Larger and more expensive applications are generally designed for use by trained and/or experienced accounting personnel in high volume business operations. A general real estate software resource for brokers is found at the end of this part one.

Ledger Operation. A new beneficiary ledger/software sub-account record is opened or established when the broker receives, as the designated contractual

custodian, any money as defined in Rule E-1 (f), or when the broker places company funds in the escrow account to pay bank operating expenses. Each beneficiary ledger is "closed" when all funds pertaining to the transaction have been disbursed according to contract, operation of law, or when the escrow bank is no longer used and any remaining funds have been distributed to the proper parties or a state escheat fund. Any interest earned on the account that appears on the monthly bank statement and that is owned by a beneficiary is recorded in the journal and the appropriate ledger(s).

Each beneficiary ledger must show the names of the parties to the specific transaction, the address or description of the property, transaction dates, check numbers, transaction amounts, a resulting balance, any appropriate deposit/receipt or transaction file reference numbers, and any other information of interest to the broker. The ending balance in an electronic accounting system may be determined when the accounts are reconciled, but care must be taken to never overspending or misuse the beneficiary's available cash balance.

Any rental income and expense and any security deposit held by the broker, will generally be reported on separate owner and tenant ledgers. To simplify record keeping for small residential property management activities per Rule E-1 (h), the tenant security deposit and rental amounts or expenses may be reported on that owner's ledger. When the broker is responsible for return of a deposit, care must be taken to never spend this money for the on-going operation of the owner's property. Security deposits must be returned in a timely manner with proper accounting per C.R.S. 38-12-103(1). The procedure for transfer of the responsibility for return of the security deposit to the owner is set forth in Rule E-16 and in the position statement on "Advance Rental and Tenant Security Deposits".

All on-going owner expenses and net proceeds should be paid from the sales escrow account directly to the parties concerned. These amounts should not be transferred to the "company operating account" for payment, as that account is the personal property of the brokerage company and is subject to other setoff or seizure rights by other business creditors. All expenses paid to sell or manage any property must be fully funded by the available cash balance held on behalf that beneficiary, unless the broker advances additional money to the owner, or other cash reserves are held in escrow pursuant to an agreement with that person. Borrowing funds from the amounts held for other beneficiaries constitutes overspending the beneficiary's ledger, creates a shortage in the bank account and is an illegal commingling of funds. An owner of several properties may authorize the broker to offset the surplus funds of one property against the negative balance of another, so long as the net result is positive on a cash basis and the ownership of the properties is identical.

The Broker's Ledger. Many banks pay interest and charge monthly fees and other costs for maintaining an escrow account. The broker may keep money in

escrow to pay these costs, conduct in-office closings, prevent possible overspending of ledger balances, and to "offset" advances of money for unexpected client/customer repairs or other unexpected "NSF" items (non-sufficient funds). This record normally constitutes an escrow account payable (liability) to the broker/company for the amount deposited. Amounts advanced from the broker's ledger must be collected as "good funds" in 45-90 days. See Appendix Exhibit J. The use of this record for a sales account is illustrated in the next Section (4).

Rule E-1 (e)(4) and E-1 (o)(5) require an accounting for any advance of money made to a beneficiary in both the journal and the beneficiary ledger affected. This practice places the broker in the role of financing the client's business activity. An alternative is to require the client to maintain a reserve balance for unforeseen emergencies and other contingencies. This is common in property management operations where there are absentee owners, variable operating expenses, or other monthly payments that require consistent collection of "good funds" from the tenants. If the broker makes an advance, it becomes that beneficiary's property and must be used accordingly. The expenditures and the subsequent repayment by the owner must be recorded on both the beneficiary's ledger and in the journal. The amount advanced must appear on the owner's accounting report and any interest charged for the advance must be disclosed in the management agreement. In a computer system the advance is represented by a deposit (debit) to the escrow cash account and a credit (non-operating income) to the specific owner's (ledger) account. Expenses and repayments are paid from the cash account and charged to the specific owner balances affected. Accounting for management commissions earned and withdrawn from an escrow account is also illustrated in the broker's ledger section of Appendix, Exhibit J.

Using "estimated" amounts due the broker without subsequently reconciling and adjusting such amounts to actual earnings for the accounting month frequently results in illegal commingling of funds. See Rule E-1 (e)(6). When real estate sales are closed in-house, any miscellaneous closing expenses and unexpected changes in service fees must be paid from the broker's own ledger and then should be collected according to the contract from the party concerned. Any uncollectable costs should not be "written-off" against the general account balance; they are paid from funds held in the broker's ledger.

The following section will illustrate the general escrow accounting concepts, use of escrow account journal and ledgers, and the bank reconciliation process. These processes apply to all other real estate escrow accounts.

(4) ILLUSTRATED ESCROW ACCOUNTING TRANSACTIONS

Background Information. You are a new business and have two listings under contract. In addition, you will manage another single-family residential property for Carter Smith and hold the security deposit for the tenant, Rose Bloom. The sales escrow account was properly established as a CARHOF interest-bearing

account. You use a manual accounting system. The following events are first recorded in the appropriate ledgers and then the journal using the transaction reference numbers indicated in (parentheses). The month of May 2014 has just ended and the bank statement was received on June 3, 2014. The May escrow bank reconciliation worksheet is shown below.

Monthly Transactions:

1. A deposit of \$250.00 is made by the broker to open the account and purchase bank records and supplies on April 1. The bank charged \$175.00 for multiple part check stock and magnetically coded deposit books. Carhof interest is assumed to be \$1.00 for April and \$10.00 for May. These amounts are withdrawn by the bank and are paid to CARHOF the next month. A "✓" means the item has cleared the account and is shown on the bank statement.

2. \$5,000.00 was received on 4-15 from Harold and Jean Blue for purchase of 7373 West Flamingo Road (This is to illustrate the use of escrow records for an in-house closing--see first closing example in the Closings course). The broker will close this transaction on 5-10.

3. The Blue's obtained a loan for \$190,750.00, which they deposit with the broker for closing. They also deposit the down payment of \$4,188.43 per the Broker's settlement worksheet (in The Colorado Closings course) on May 5. The broker makes all disbursements per the credit column on the settlement worksheet and pays the seller's proceeds on May 15th in "good funds."

4. Rose Bloom rents Carter Smith's home on May 1, for \$1,500.00 per month. Rent is due on the 5th and the tenant also pays the \$1,500.00 security deposit due per the lease. The broker charges 10% of the gross rent as the management fee, and pay the owner's monthly mortgage of \$800.00 no later than the 15th. The tenant pays all utilities and trash directly to the city vendor. The management fee is scheduled to be withdrawn on the last day of the month. Proceeds are mailed on the owner by the 10th day of the next month.

5. Carter Smith gives the broker a check for \$175.00 to repair the furnace on May 29th at an estimated cost of \$175.00. The bank returned this payment as "NSF" on 30th after the broker mailed the monthly proceeds check. Smith repaid this amount in cash on June 1. (NOTE: The tenant deposit must be held intact as a refundable security deposit. If the furnace repair cost is actually \$300.00 and is paid on the May 30th, this "theoretical" expense would be partially offset by the \$85.00 balance on the Broker's ledger and the \$1,200.00 in the owner's ledger, however, and an "unfunded amount" of \$215.00 would have been "borrowed" from the tenant's security deposit in violation of Rule E-1 (q). This is an example of an event the broker must properly handle in property management.)*.

Ledger Entries By Date:

<i>Broker's Ledger Record – Sales Escrow Account - Page 1</i>							
<i>Ref</i>	<i>Date</i>	<i>Check</i>	<i>Description</i>	<i>√</i>	<i>Payment</i>	<i>Deposit</i>	<i>Balance</i>
(1)	4-1		Broker Funds to Open Account	√		250.00	250.00
	4-1	101	Checking Supplies Purchased	√	175.00		75.00
	4-30	Bank Credit	Carhof interest earned April	√		1.00	76.00
	5-1	Bank Debit	Sweep Carhof interest April	√	1.00		75.00
	5-30	Bank Credit	Carhof interest for May	√		10.00	85.00

Buyer Ledger: Harold & Jean Blue, 111 1st Ave., Salt Lake UT **SELLER:** John & Mary Gray
LISTING: 4/01 **NEW ADDRESS:** 7373 W. Flamingo Road, Lakewood, CO

CLOSING DATE: May 10

CLOSED: May 10

<i>Ref</i>	<i>Date</i>	<i>Check</i>	<i>Description</i>	<i>√</i>	<i>Payment</i>	<i>Deposit</i>	<i>Balance</i>
(2)	4-15		Earnest Money Deposit	√		5,000.00	5,000.00
(3)	5-10		Lender Loan Proceeds	√		190,750.00	195,750.00
	"		Down Payment for Closing	√		4,188.43	199,938.43
	"	107	Acme Loan – Payoff of 1 st	√	46,450.00		153,488.43
	"	103	Title Ins. – Mortgagee Prem.	√	575.00		152,913.43
	"	104	County Clerk recording/release fees	√	62.00		152,851.43
	"	105	Buyer's Attorney – title exam	√	75.00		152,776.43
	"	106	Dept. of Rev – State Doc fee & 2%	√	4,095.38		148,681.05
	"	107	County – Tax Certificate	√	15.00		148,666.05
	"	108	Lender Tax Reserve	√	854.65		147,811.40
	"	109	Hazard Ins. Premium & Reserve	√	787.50		147,023.90
	"	110	1% Origination fee & interest on new loan	√	2,769.79		144,254.11
	"	111	Survey Cost	√	65.00		144,189.11

	"	112	Lender Credit Report Company	√	50.00		144,139.11
	"	113	Broker's Commission	√	11,400.00		132,739.11
	"	114	New Lender's Atty – title exam	√	75.00		132,664.11
	"	115	Broker – document preparation	√	100.00		132,564.11
	"	116	Seller's Net Proceeds Paid	√	132,564.11		0.00

TENANT: Rose Bloom (303-000-0001) **OWNER:** Carter Smith (303-000-0000)
RENTAL: 123 W. Flamingo Road **OWNER ADDRESS:** 10050 Grape Ct., Lakewood, CO 80213
Rent per Month: \$1,500/mo due on 5th **BANK:** United National Bank, Loan #xxxx-xx – Due on 15th
Sec. Deposit Held: \$1,500.00 **Lease Expires on:** 5-1 next yr **Management Fee:** 10% of Gross Rents

Ref	Date	Check	Description	√	Payment	Deposit	Balance
(4)	5-5		Rent and security deposit for Rose Bloom – 1 yr. Lease	√		3,000.00	3,000.00
	5-10	117	United National Bank loan	√	800.00		2,200.00
(5)	5-29		Owner funds to repair furnace	√		175.00	2,375.00
(4)	5-30	118	10% Management fee	√	150.00		2,225.00
	"	119	Owner Proceeds May 2007	√	550.00		1,675.00
(5)	"	(Actual Month end balance)	Owner deposit was NSF	√	175.00		1,500.00
	"	(Theoretical for illustration only)	Assumed but not actual repair of furnace to illustrate a shortage in the Sec. Deposit*		300.00*		1,200.00*

The total funds actually held in escrow for all pending ledgers at May 31 is \$1,585.00 (\$85.00 + \$1,500.00). This agrees with the month end journal balance shown below. Please note: the journal below is presented in very abbreviated form to save publishing space; this should not be done in actual practice:

SALES ESCROW JOURNAL May - Page 1 of ____							
Ref	Date	Check	Description	√	Payment	Deposit	Balance
			Balance Forward from April 30, 2007	√			5,076.00

(1)	5-1	Debit	Bank Interest Sweep	√	1.00		5,075.00
(4)	5-1		Rose Bloom Rental % Sec. Deposit – May 07	√		3,000.00	8,075.00
(3)	5-10		Blue Loan & Down Payment	√		194,938.43	203,013.43
	“	102- 116	Blue Closing, 7373 W. Flamingo	√	199,938.43		3,075.00
(5)	5-29		Bloom Repair Deposit – Smith	√		175.00	3,250.00
	5-30	Debit	Bloom Repair – Smith NSF	√	175.00		3,075.00
(4)	5-10 to 5-30	117- 119	Bloom – Mortgage, rental expense, Commission and Proceeds	√	1,500.00		1,575.00
(1)	5-30	Credit	Record Carhof Interest May 2007	√		10.00	1,585.00

The Bank Reconciliation Process. The purpose of reconciliation is to verify that the records for the account are in balance per the escrow accounting equation. The bank reconciliation worksheet form is shown in the Appendix, Exhibit D.

Rule E-1 (o) (3) requires the ending bank statement cash balance to be reconciled with the office journal and ledger account cards during any month when there has been escrow account activity. Each open ledger balance (not just a lump-sum total) is individually listed on the left side as shown below, or in additional attached sheets if necessary. The ending journal balance on the date of reconciliation is entered underneath the total for all pending ledgers. The bank balance is reconciled on the right side of the worksheet; it must balance with the cash shown in the journal and all ledgers. It is recommended that the "date of reconciliation" be the date of the latest bank statement, even though the actual date of performing this process is usually later.

Assuming that the bank statement balance on May 30 is \$ 1,585.00, and that there are no outstanding items, or errors on the statement, the Reconciliation Worksheet below would be prepared using the data above. In addition, the broker should carefully perform the verifying tests noted below.

<i>Mile High Realty Sales Escrow Account 000-0000-0</i>		<i>Date Reconciled: June 5</i>	
<i>Bank Reconciliation for month ending May 30, 20</i>		<i>Date of Reconciliation: May 30</i>	
<i>Prepared by: Linda Smith</i>		<i>Reviewed by: John Smith,</i> <i>Broker</i>	
<i>Escrow Liabilities per Pending Ledgers on 5-30</i>		<i>Ending Bank Statement Balance</i> <i>\$1,585.00</i> <i>5-30</i>	
<i>Description</i>	<i>Ledger</i>		
<i>Broker's (Company) Ledger</i>	<i>\$85.00</i>	<i>Add: Outstanding Deposits mailed to bank on</i> <i>or before May 30</i>	
<i>123 W. Flamingo Security Deposit</i>	<i>\$1,500.00</i>	<i>\$ 0.00</i>	
		<i>Subtotal</i> <i>\$1,585.00</i>	
		<i>Subtract: Outstanding Checks</i>	<i>\$ 0.00</i>
		<i>Reconciled Bank Balance:</i> <i>5-30:</i>	<i>✓ \$1,585.00</i>
<i>Total Pending Ledgers 5-30</i>	<i>✓\$1,585.00</i>	<i>* This means all records agree with the actual escrow liabilities per the contracts and all banking activity is properly reported in the accounting records</i>	
<i>Ending Journal Bal. 5-30</i>	<i>✓\$1,585.00</i>		

For simplicity, the commission recommends reconciling the bank balance to the ending checkbook and journal cash balance per the office records, but other accepted methods may be used, e.g. reconciling the books to the cash in the bank, and/or using a "four column cash reconciliation," with a supplemental listing of all pending ledgers and outstanding items on attached sheets.

All contracts must be examined to confirm that the total amount of money that should have been received has been properly deposited. Investigate and correct any errors or omissions immediately. Any transfer of funds between related accounts must be made in a timely manner, i.e. rent and security deposit payments combined on one check. If this is not done, a shortage will develop in the security deposit account, and refundable deposits may be erroneously paid to property owners as net proceeds. Collecting these amounts later may be difficult.

An authorized independent company custodian should have personal responsibility to account for retention, access and the use of banking records, receipt books, computer back-ups and hard copy printouts of all accounting records. Someone independent of the accounting department should review monthly bank reconciliation and the items listed for errors or other irregularities. The reviewer should trace transfers and outstanding items to subsequent payments and deposits on later statements. Look for unrecorded statement items or those that are contrary to other company policy and practices.

(5) TRANSACTION FILES AND THE RETENTION OF RECORDS

The records of licensed brokerage activity must be retained for **four (4) years**. Rules E-4 and E-5, as well as the Commission Position Statement On Record-Keeping (Chapter 16) control the contents of the broker's property transaction file. Rule E-3 requires any licensee to produce appropriate records concerning licensed activity and operation of the trust accounts upon the request of the commission.

Except for times in which the documents are being reviewed or executed, the current transaction files should be kept at the broker's office in a secure, central location. The broker should review all pending sales transaction files and any leases and management agreements executed by associates for possible correction or follow-up attention. A copy of the earnest money check with a copy of the deposit slip should be placed in the transaction file. Associates may retain copies of contract documents (and pay for them) according to the broker's office policy or employment agreement.

"Duplicate signatures" are acceptable for all records maintained in the broker's transaction file per Rule E-4. "Duplicate" means photocopy, carbon copy, or facsimile, or electronic copies that contain a digital or electronic signature as defined in 24-71-101(1) C.R.S. Paragraph 26 of the current approved contract form may be checked to require that original signatures be furnished to the parties concerned at or before the closing. Copies of documents provided to the brokers at the closing may be authenticated by the closer's notation to the effect that: "This is a complete copy of the original document executed by the parties to this transaction."

A broker shall maintain a duplicate of the original of any document (except deeds, promissory notes and deeds of trust or mortgages prepared for the benefit of third party lenders) which was prepared by or on behalf of the licensee and pertains to the consummation of the leasing, purchase, sale or exchange of real property in which the broker participates as a broker. The payoff statement and new loan statement monetarily affect the settlement statement and should be retained by the broker concerned. Cooperating brokers, including brokers acting as agents for buyers in a specific real estate transaction, shall have the same requirements for retention of duplicate records as is stated above, except that a cooperating broker who is not a party to the listing contract need not retain a copy of the listing contract or the seller's settlement statement.

A broker is not required to retain copies of existing public records, title commitments, loan applications, lender required disclosures or related affirmations from independent third party closing entities after the settlement date. The broker shall retain documents bearing a duplicate signature for the disclosures required by Commission Rules F-5, 14, 15 and 19. The broker engaged by a party shall insure that the final sales agreement, settlement statement, or amendment of the settlement, delivered at closing for that party's

tax reporting or future use, shall bear duplicate signatures or as authorized by the parties concerned.

The following is a checklist for common records to retain in the both the listing and selling broker's property transaction file. Other ancillary documents and agreements executed between the parties and the closing entity or lender are not required.

SALES FILES

- Lead-based paint disclosures for residential property built before 1978
- Exclusive right-to-buy/sell, or agency or open listing agreement (listing broker only)
- Disclosure of brokerage relationships
- Disclosure of compensation for services and income from affiliated entities
- Disclosure of the source of residential property square footage
- Contract to buy/sell/exchange real estate
- Current marketing/MLS information used in the transaction
- Seller's property disclosure statement
- Actual closing instructions--negotiated before the actual date of closing
- Copy of any power-of-attorney (show recording data if closed in-house)
- Copy of earnest money check, validated escrow bank deposit slip (or receipt below)
- Signed and dated receipt for earnest money held by third-party closing entity
- Copy of earnest money note
- Buyer's financial information—if "owner-carry" financing
- Rental/occupancy agreement before closing date (have separate security deposit)
- Estimated closing costs/estimated monthly expenses prepared by licensee
- Settlement statement (or equivalent computer form) for the party represented or assisted
- Side agreement/amendment to revise a settlement statement
- Promissory note (unsigned, marked "COPY")
- Closing entity commission check remittance less earnest money amount if applicable
- Tax reports required by government agencies (Colorado withholding tax)**
- Escrow receipts or collection agreements--continuing after closing
- Accounting for use of advance retainer fees
- Six-column worksheet for settlement (or equivalent computer form)**
- Deed (copy showing recording data if closed in-house) **
- Deed of trust (copy showing recording data if closed in-house) **
- Other legal documents prepared by the broker **

****Required only when the broker personally prepares the document, conducts the closing in-house without use of a title company and/or is responsible for recording of any documents.**

MANAGEMENT FILES

- Current/past management and/or short-term reservation management agreements
- Current/past lease or rental occupancy agreements with tenants and guests
- Lead-based paint disclosures for residential property built before 1978
- Disclosure of brokerage relationships
- Disclosure of compensation, service income from affiliated entities
- Brokerage accounting records, bank reconciliation, tax and owner reports
- On-going contracts, bids, invoices, service provider billings, correspondence with client
- Legal notices, actions, accounting reports affecting owner/occupant/tenant funds
- Documentation for commissions earned vs. taken/charged to others
- Prompt assessment, timely (45-90 days) collection, restitution of all money due escrow
- Documentation verifying reported receipts, income and all expenses paid for another

(6) ADMINISTRATIVE MATTERS

Changing Employing Brokers. Each corporation, partnership, or limited liability company is recognized as a distinct, licensed entity. The designated natural person, i.e. the "employing" or "acting" broker, is responsible for the on-going maintenance of all records concerning licensed real estate activity and supervision of the escrow accounting process.

If the acting broker leaves employment with the licensed entity, the licensed entity retains the continuing responsibility for maintenance of all escrow records. The departing broker is personally responsible for delivering these records to the licensed entity, and must properly account for all trust funds transferred to the new broker. The acting broker serves only as a caretaker or trustee during the period of licensed tenure as the acting broker. A form for documenting a change in broker is found in Appendix, Exhibit I.

An exception to this situation occurs when a licensed business entity is dissolved. The final acting broker then becomes personally responsible for making all final disbursements and accounting for all trust funds. That broker must maintain all records for a period of four years. Upon dissolution of an individual proprietorship, records maintenance remains the responsibility of the individual proprietor broker and his or her heirs. Closing the business and the pending transactions should be done according to the Commission position statement on "Assignment of Contracts and Escrowed Funds." An attorney or

another qualified unlicensed party may complete this process on behalf of the surviving heirs of the individual proprietorship. The forms for applying for a transfer or change in the broker's license status may be found at: www.dora.state.co.us/real-estate/applics/applics.html. See Rule A-26 for the process of securing a temporary business entity broker license.

Good Funds. Rule E-36 requires that "good funds" be held and disbursed for closing. Such money is: (1) immediately available for withdrawal as a matter of right from the financial institution where deposited, or (2) is available for such withdrawal as the consequence of an agreement of an institution in which the funds are to be deposited or a financial institution upon which the funds are to be drawn. The agreement must be for the benefit of the licensee providing the closing service; all contingencies and conditions must be satisfied before any funds may be disbursed. Good funds are required for closing by the Colorado Consumer Protection Act, 6-1-105(1)(v) C.R.S.

Examples of good funds are: cash, wire transfers, telephone transfers between accounts in the same bank, cashier's checks, certified checks, teller checks (issued by a savings and loan), tri-party agreements in which the financial institution unconditionally guarantees the lender's check, deposits of earnest money which clear the buyer's bank before closing, transfers of a buyer's earnest money to a closing agent (with prior consent of the parties) which clear the broker's bank before closing, offsets of earnest money deposits against earned commissions by the closing agent, and Federal Home Loan Bank checks.

Closing Instructions. The Colorado division of insurance requires that written closing instructions be provided to the closing entity for any real estate transaction. The commission closing instructions are found in Chapter 21 of the MacIntosh Real Estate School Colorado Course Book II and are required by Rule F-17. The commission's closing instructions or an equivalent form shall be delivered to the closing agent in time to prepare the final settlement.

Signing Settlement Statements. Rule E-5(d) requires the licensee to sign and approve the settlement statement of the party they assist or represent. The settlement statement must also show the name of the employing broker where applicable. The Commission recommends that each licensee and supervising broker review the final contract and proposed settlement statement before closing. Rule E-5(d) states that the licensee is responsible for furnishing a proper settlement statement at closing.

If the licensee is unable to attend the closing, an alternate may be designated to attend on the licensee's behalf. In this case, both the licensee and the alternate who consents to attend a closing on behalf of the absent licensee, are responsible for the accuracy and delivery of the settlement statements and other closing documents.

The employing broker is responsible to see that the licensee is competent in such responsibilities. A copy of the signed settlement statement shall be delivered to the employing broker immediately after the closing. Original signatures are no longer required for the broker's transaction file.

If the closing involves a new loan made to the purchaser where the lending institution deducts costs before distributing the loan proceeds prior to final settlement, the loan proceeds must be reconciled with the amounts due to/from the seller and buyer. The new loan reconciliation is described and illustrated in Colorado Closings course of the MacIntosh Real Estate School Manual. The broker's debit and credit columns of the "Worksheet for a Real Estate Settlement" or an equivalent closing entity form may be used for this purpose. The reconciliation must also be delivered to the employing broker after closing.

Closing Fees. The position statement (Chapter 16) and Rule E-37 provide that there is no obligation for a broker to prepare any legal document as part of a real estate transaction or closing. However, as the result of the *Conway-Bogue* court case decision (Chapter 16), brokers may prepare certain legal documents and complete standard and approved forms.

Certain fees are generally charged for preparation of real estate documents and closings: (1) a fee for closing and preparing non-legal documents such as the settlement statements, and (2) a fee for preparing legal documents executed by the parties, i.e. contracts, deeds, notes, deeds of trust, mortgages and other security instruments. Upon agreement of the parties, fees for preparing non-legal documents may be charged to anyone. However, in the absence of an attorney representing one of the parties to the transaction, the broker must pay any fees for preparing legal documents. The broker must ensure that the proper parties pay for the closing costs. Brokers may charge (with written authorization from the parties) for the transactions that they close "in-house", when such charges are not tied to preparation of legal documents. The broker may not designate his/her own attorney to prepare the documents, and then pass these charges to the parties, as if the attorney were representing them.

IRS/State Reports. IRS Form 8300, "Report of Cash Payment Over \$10,000", received in a trade or business, must be filed when cash (currency) is received by the broker from the same person in any one year as the result of single, connected or related transactions. The report and further instructions may be obtained at the IRS website: www.irs.ustreas.gov/forms_pubs/index.html. Civil and criminal penalties may result from a failure to comply with reporting requirements.

Sellers must provide the closing agent with their complete name, address and taxpayer identification number or social security number for reporting income from the sale or exchange of property. The person who actually provides the closing service makes this report on Form 1099-S. **The Colorado Department**

of Revenue requires withholding 2% of the sales price OR the net proceeds shown on the bottom of the settlement statement, whichever is less, from the sale of Colorado property in an amount of \$100,000 or more by non-resident individuals, including foreign partnerships and corporations not registered with the Secretary of State, or having no Colorado business address immediately following the sale. The tax must be withheld and the forms prepared by the individual or entity actually providing the closing service. This is reported on Form DR 1083 and is remitted with payment on Colorado Form 1079. Further instructions, exemptions and forms may be obtained by calling the Colorado Department of Revenue at (303) 232-2446. See basic text of this law in Chapter 20, 39-22-604.5 C.R.S.

Private Bank Account Insurance. Brokers may be able to purchase private insurance coverage for all escrow and operating checking accounts with deposits in excess of the FDIC coverage as added protection from a bank failure. Information on such coverage can be obtained from the broker's insurance agent.

Computer Forms. Personal computers may be used to generate standard and approved forms if the following requirements are met: (1) the Commission approved language must be exactly reproduced; (2) the software must not allow alteration of the approved standard language in day-to-day operation; (3) the software must produce fill-in and allowable transaction-specific language in a font clearly differentiated from the standard, approved contract language. (4) the contract print must be easily readable; (5) blank spaces shall not be filled in by the licensee, prior to negotiation with the parties. See the discussions of Rule F in Chapters 15, 16 and 21.

Software Resources. The commission does not recommend or endorse any specific software and provides the following information for further investigation and analysis by the licensee: (1) Texas A&M University, Texas Station (1-800-244-2144) publishes a synopsis of current software (400+) applications available for real estate firms. This information is available on either a Windows disk or in book form. (2) Institute of Real Estate Management, P.O. Box 109025, Chicago IL. 60610 - 9025 (FAX 1-800-338-4736). Colorado chapters may be contacted through C.A.R. (303-790-7099).

Commission Audits. Statewide examinations are conducted in response to public complaints or on a routine cyclical basis. The examination is performed on-site to examine the handling of escrow funds and the maintenance of other required business records. The broker is selected from the licensing database of eligible brokers or registered developers. Audits of certain brokers and developers may be done by correspondence. Upon completion of an audit, the examiner will meet with the broker or registered developer's representatives to discuss any findings. The examiner will then mail a written report of the results to the broker for explanation and correction. All completed audit reports are filed

electronically for future reference. It is important for brokers to insure prior corrections continue to be followed. Repeated findings are considered matters that warrant official Commission action.

PART THREE - PROPERTY MANAGEMENT RECORDS

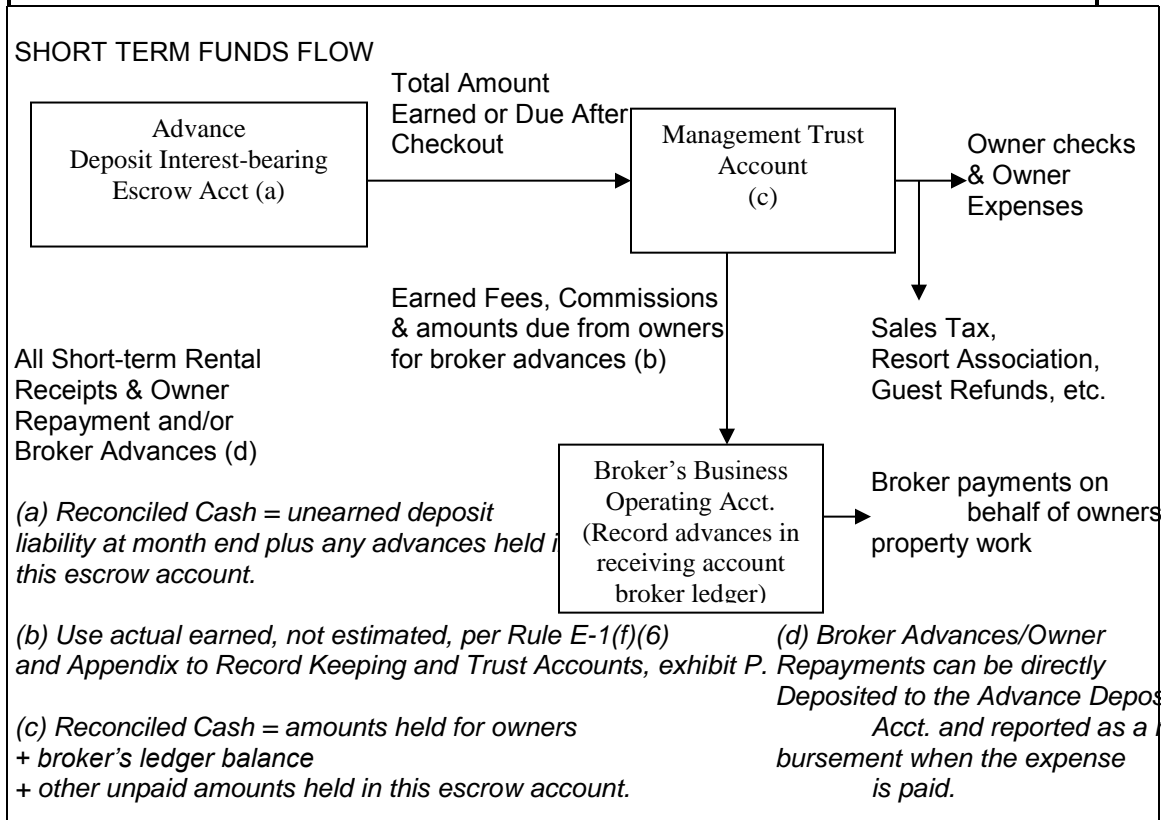
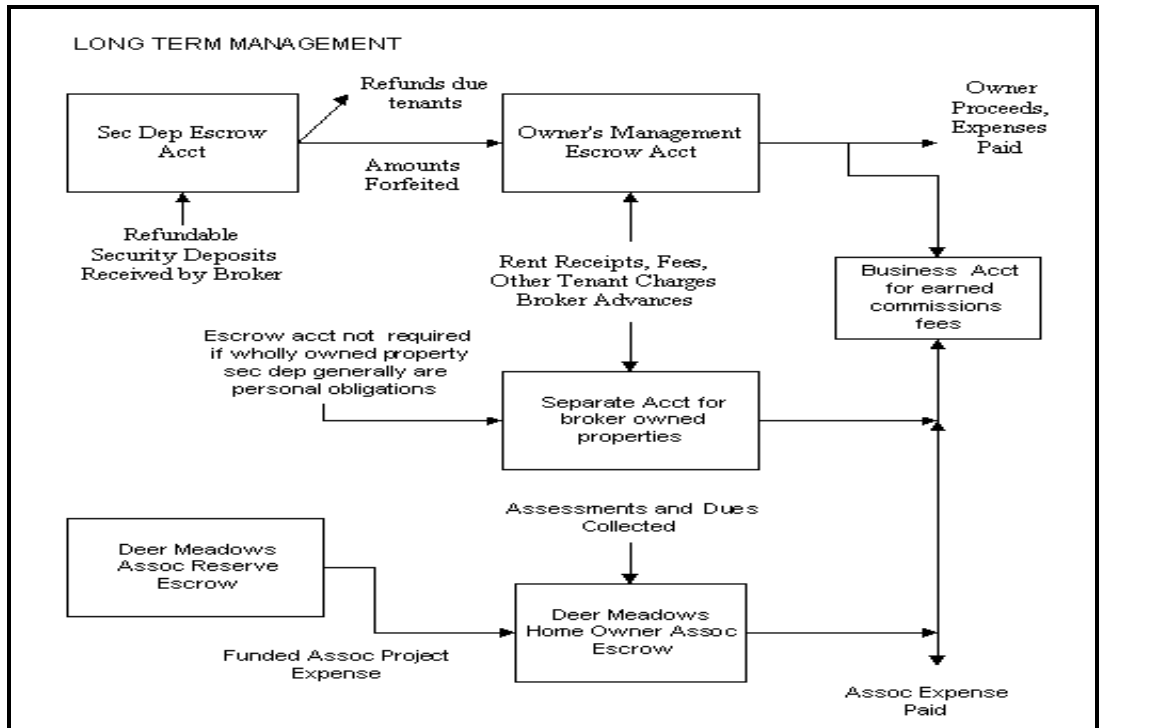
1) MANAGEMENT ACCOUNTING REQUIREMENTS

General Concepts. The responsibilities and concepts described in Parts One and Two become more critical in the supervision of property management activities.

The accounting cycles are more complex and intensified, as more transactions must be processed in a shorter time. The financial interest of each beneficiary must be maintained to prevent illegal commingling of funds. On-going operations must be effectively managed to maintain accurate and timely records, while administering customer and client services each month.

The management activity undertaken will affect the accounting system used, and care must be taken to choose the type of product best suited for the proposed business operation. If software is used, it must: (1) Classify and report current, year-to-date, and selected period financial information pertaining to the financial interests of the owner, tenant, and any related homeowner association by property and unit managed on the cash and accrual basis; (2) Control cash flows and on-going expenditures; (3) Produce current or prior bank account reconciliations with the corresponding escrow liabilities in detail upon demand; (4) Account for the use of different escrow bank account structures shown on previous pages; (5) Track managerial and administrative information for the property manager and owner; (6) Emphasize the "custodial/trustee responsibilities" of the Colorado broker in "accounting for the funds of others," as distinct from the "ownership/ investor role" used in most commercial software design and operation.

Account Structures and the Flow of Funds. A typical full-service management company would generally have the following account structures for "long" or "short" term management operations involving associations and broker-owned properties. These activities were introduced in Part Two.



Account Operation. The accounts illustrated above may exist in addition to the sales escrow account. Information on how to establish and identify a required escrow bank account is found in Part Two, Section (2). Separate long and short-term bank accounts are not required if the records differentiate and report each

activity separately. However, management of associations of more than 30 units require the use of separate bank accounts for each association and individual reserve fund (C.R.S. 38-33.3-306(3)(a)).

Residential property management duties may range from simple upkeep and caring for the absentee owner's property, to the management of large apartment and commercial complexes or common interest owner associations, to managing short-term resort properties for many different owners. The basic accounting records for such activities were illustrated in simple form in Part Two, Section (4). Basically, the manager receives inflows of escrow cash from tenants/guests in the form of rent, HOA assessments, other special fees, advance rental deposits, refundable security deposits, owner cash reserves, or reimbursements for broker advances, and pays this money out to third parties as various owner and tenant expenses, refunds, or rental proceeds. In addition the broker may manage reserves for future expenditures or improvement funds.

Internal Controls. An effective and efficient "internal control structure" must be developed for business operations in order to establish personal accountability for performance of the critical steps of the company's accounting cycle. Professional advice is recommended as the size and complexity of the business increases. The structure must adequately separate and monitor three basic "incompatible" functions: (1) the transaction authorization and approval process, (2) the responsibilities for the physical control and custody of the escrow assets and/or the records creating or changing escrow liabilities, and (3) the accounting, record-keeping and external reporting functions. The employing broker must avoid delegating job duties in a manner that allow one person to independently perform and/or supervise all three functions from start to finish. Some guidelines concerning these functions based on audit findings are:

- The responsibility for collection of company receipts and making the corresponding bank deposits should be separated, and be separate from the responsibility for maintaining the accounting records;
- Avoid combining the responsibility for the custody for any escrow asset with the independent ability to control the related transactional information and/or the create or alter the corresponding contractual records of the liability;
- The responsibility for authorizing write-offs and/or adjustments to amounts due the company should be based on independent collection efforts by a third party or the employing broker's own investigation of the facts reported;
- The responsibility for conducting licensed activity on behalf of the employing broker should be separated from the responsibility for maintaining the primary accounting records and/or controlling the reporting processes associated with those efforts;

- The broker should maintain full disclosure and reliable sources of on-going, unfiltered communications with all parties affected by operating policies involving potential conflicts of interest;
- The broker must be alert for and monitor circumstances which may give rise to the means, motivation or opportunity for misuse of funds, e.g. accepting cash (legal tender), signing checks in blank, using cash receipts as a petty cash fund, not verifying voided or outstanding checks and deposits in the bank reconciliation, etc.

A "self-authenticating" cash receipt and/or coversheet deposit form, with the detail information required in Rule E-1 (o)(6) should be used to account for the physical custody and deposit of cash. The receipt must be signed and dated by a designated "cashier" and the person making the payment; the person paying must maintain the carbon receipt as proof of payment. The person collecting receipts must formally account for all receipts in his/her custody monthly, and for the receipts given to a designated "courier" for deposit; both the cashier and courier must count and countersign a dated cover sheet showing the receipt numbers and individual amounts included in each bank deposit. A ranking independent staff member should compare the monthly amounts due per the rent receivable roll, pending folios and leases with the corresponding bank deposits and verify the receivables due are accounted for and were properly deposited. Any delinquent or missing receipt items should be confirmed with the party concerned and immediately reported to the employing/supervising broker. Each cash receipt form should be magnetically coded and numbered to simplify the reconciliation process by appearing on the monthly bank statement like returned checks. Some companies require the use of money orders from nearby banks as an alternative to handling cash receipts and then allow tenants to deduct the order cost from the rent due.

Authority to make telephone transfers or electronic withdrawals should be limited to the broker and a knowledgeable manager. The bank should receive written instruction to verify the identity of the caller and record this with the correspondent teller's name on each returned transfer/withdrawal form.

In the short-term management, all guest receipts should be deposited directly into the advance rental/security deposit account to insure: (1) there is only one authorized point of entry into the escrow accounting system, (2) there is greater control over the transfer of earned income and miscellaneous receipts into the management escrow account, (3) there is one account for distribution for all authorized payments to others, (4) any authorized brokerage income from the proper use of an interest bearing account can be maximized, and (5) the use of manual checks prepared outside the normal accounting system may be avoided or closely monitored by the designated broker.

All used/unused company deposit slips, pre-numbered receipt books, sequentially numbered receipt forms and blank check stock must be must be

accounted for periodically and limited to controlled usage by authorized persons. Access to this inventory should be assigned to a specific person and/or the broker. Unused or new pre-numbered receipts, receipt books, check books, and unused stock should never be left unsupervised outside the control of an authorized custodian. Unnumbered bank items are difficult to control and costly to account for, but are always easy to misuse.

In long-term management, payments to vendors, owners and tenants should generally be made from the account where the amount was first deposited. When the use of separate escrow bank accounts is required, some incentive may be given to encourage the separate payment of rent, security deposits, or other amounts requiring use of separate escrow accounts. Company policy should require tenants to use separate checks that can be deposited directly into the proper account. Every internal transfer duplicates the cost of accounting and increases the risk of error, misapplication, or theft. This policy should accommodate good business practice and occasional tenant hardships. It should require preparation of a corresponding escrow check to transfer the necessary amount to the proper account at the same time the customer's check is deposited. Failure to properly identify and transfer this money results in a corresponding shortage in the security deposit account. This error will not be easy to find if the identity of the tenant and the amounts paid aren't shown individually on the deposit slip per Rule E-1 (o)(6).

Unrecorded or uncorrected non-sufficient funds (NSF) items, or bank errors will create a similar problem in the owner's management escrow account. NSF items may be offset by money maintained in the broker's ledger. The appropriate amount should be based on normal rates of occurrence. The use of the broker's ledger records was described in Part Two, Section (3) and is illustrated in Section (4).

Creation of an Unlicensed Company. Brokers who allow associates to manage property or perform real estate related services on the broker's behalf through the licensed brokerage entity are generally responsible for the results, and must supervise those activities per Rules E-29 through E-32. A licensee may also sell and/or manage personally owned property as a private party with disclosure per Rule E-25. In this case, the licensee must avoid any impression that this activity is performed on behalf or his/her broker in a licensed capacity. See the position on the "Sale of Items Related to Real Estate," in Chapter 16. A licensee who performs any exempt activity, is still subject to the jurisdiction of the Commission. See Seibel v. Colorado Real Estate Commission in Chapter 16 and C.R.S. 12-61-113(1)(g) in Chapter 14.

The licensee has the general duty to act honestly and in good faith, to properly remit any funds received, and to perform all duties promised. The escrow accounts and records prescribed by Rule E-1 and E-1 (o) are not required in by license law for this activity.

Broker who acts as a "Conduit." A "conduit" means that the broker only collects money on behalf of another and deposits the same to the owner's bank account without any additional signatory power or right of withdrawal. No trust account is required in this case. The broker should have a written agreement as to the duties required and keep a record showing the collection and proper deposit to the owner's account for any funds received.

REQUIRED MANAGEMENT RECORDS

The following ledger records are required to control and account for money belonging to others. These are in addition to the escrow bank accounts and the journal described and illustrated in Part Two, Sections (2) and (4).

Tenant/guest Rental Ledger. This record shows each customer's payment history, any amount due plus other fees or charges. For single-family management, the tenant's payment information may be kept on the owner's ledger card, but in multi-family (apartment) management a separate record should be kept for each tenant renting a unit. The use of a "continuous tenant ledger by unit" (for each unit rented) lends itself to errors and internal misuse of funds because the amounts held or due for a specific tenant are difficult to isolate. See Exhibits E and F in the Appendix.

A different ledger form is used for short-term management and is called the guest folio. It may be designed to suit company needs. The form must facilitate accounting for all unearned advance deposits in the monthly bank reconciliation; it also accounts to the guest for the amounts received and due on the check-in date, and contains the following general information:

Folio Number: _____	Guest Name _____
Dates of Stay _____	Rental Address _____
Reservation Confirmation No. _____	Reservation Date _____
Guest Address and Telephone No. _____	
Nights Rented _____	X Rate per/night \$ _____ = Total Due \$ _____
Less Travel Agent Fees & Discounts (_____)	
Add Security or Advance Deposit Due to the Company _____	
Special Packages Ordered by Guest _____	
Total Amount Due Company from Guest by Check-In Date: \$ _____	
Less Amount(s) Paid on _____ by _____ (_____)	
" _____ (_____)	
Balance Due at Check-In " _____ \$ _____	
Refund/Cancellation Paid Guest on _____ by Check _____	
(Company refund policies and other disclosures are printed and mailed to the guest upon receipt of a reservation).	

The Owner's Ledger. All cash received or paid in managing the owner's property is itemized by individual transaction on this record. This ledger may be used to prepare a separate owner accounting report, or may be mailed as the

monthly statement with any net amount due to or from the owner. A sample form is found in Exhibit G.

Proper maintenance and scrutiny of the owner cash balance reported is the easiest way to prevent illegal commingling of funds between individual same-owner properties in a "pooled" escrow account. If the owner lacks the necessary capital in one property, the broker may transfer the funds needed from another identically owned property, assuming there is a surplus on the other property ledger and the transfer is authorized in the management agreement. If there are no additional owner funds on hand, then as a business decision consistent with the terms of the management agreement, the broker may advance the money needed from the broker's ledger, and reimburse this advance from the owner's future income. The procedures for making an advance of funds from the "broker's ledger" were discussed in Section (3) of Part Two. The various uses of the broker's ledger make it an absolute necessity in any escrow accounting or software system.

In short-term property management, the owner's share of advance rental deposit income and the expenses paid by the broker are reported on the owner's ledger after the checkout date. The amount earned is transferred into the owner's management escrow account. The owner's accounting report shows the disposition of any security deposit held, the rental fee earned during the month by guest name or folio number, any amounts refunded, the broker's fee, any advances due or repaid, plus any other operating expenses paid on behalf of the owner per the management agreement, and the current and year-to-date summaries of the net proceeds for each unit managed. The reported items must reference specific guest reservations, folios and other appropriate business documents per Rule E-1(o)(4) by unit number and date, e.g. receipt numbers, vendor billings, invoices, paid check numbers.

The Owner's Property File. This file contains all records of the broker's performance of duties and obligations required by the terms of the management agreement, lease, or short-term occupancy contract. It is similar to the "closing file" maintained by sales brokers and should contain the following records: (a) management agreements/ amendments and addendums; (b) leases, reservation policies, and occupancy records and agreements with guests; (c) legal notices affecting the tenants or occupants and disclosures required by the Commission; (d) on-going vendor or service provider contracts, competitive bids and estimates, invoices, vendor billings and owner authorizations for repairs or special maintenance work apart from that contained in the management agreement; (e) monthly accounting reports, tax reports or other information required by federal agencies affecting the use or disposition of money belonging to others; (f) schedules or reports of commissions and fees earned; and (g) evidence showing assessment and timely collection (45-90 days) of all money due to the broker's escrow account. See "Retention of Management Records", in Section (6) of Part One.

Tax Reports. The accounting data maintained by the broker as the agent for the owner is reported on IRS Form 1099. Information on reporting duties and supplies of forms are available from the IRS. State tax information may be obtained from the Colorado Department of Revenue. City and county tax reporting is required and should be discussed with the business tax representatives concerned.

Business Licenses. Brokers who rent short-term occupancies must first obtain business licenses and register such activity (when required) with local authorities. The broker must collect and remit state and local sales and use taxes, and maintain the necessary accounting records for inspection by other agencies. State tax information is available from the State Sales Tax Division at the Colorado Department of Revenue. Contact the local city and county offices for additional information concerning possible professional licenses or registration of business activities required in your area.

Management Reports Provided to Owners. The broker is required to provide an accurate and timely accounting report to the owner for the stewardship of funds received or disbursed on behalf of the owner. In the absence of another agreement, commission rules E-1(o)(4) and E-2 require an accounting report be furnished to a property owner within thirty (30) days of the end of any month in which such funds were received or disbursed. A sample form is shown in Appendix Exhibit H.

The accounting report may show totals for various classes of income and expenditures, provided other detail is maintained to identify the individual receipts and expenditures included in the totals. The most common forms for the reports to owners are: (1) the "balance sheet and income statement," and (2) the "owner's statement of account." The statement of account is usually a manual tabulation of the beginning management cash balance plus receipts less payments equals ending cash balance. The same formula may be used to report or analyze the changes in other trust accounts.

The owner's accounting report must be complete and accurate in reporting management operations. Escrow account transactions are generally reported on the cash basis. Care must be taken to report factual data, e.g. expenditures charged to the owners on the report implies that checks have been mailed and are not being held in the broker's office, income reported has been fully collected and cash balances for various trust accounts are accurate representations of the owners corresponding rights and obligations with respect to these accounts.

Commissions Earned and Paid. Commissions and fees are a matter of contract between the broker and the parties concerned. The contract should be written to avoid confusion and disputes over the actual terms. Rule E-1 (e) (6) states: "In the absence of a specific written agreement to the contrary, commissions, fees

and other charges collected by a broker for performing any service on behalf of another are considered 'earned' and available for use by the broker only after all contracted services have been performed and there is no remaining right of recall by others for such money."

Two accounting practices are followed for the withdrawal of fees and commissions from the escrow account. The "accounting rule" provides that such fees are not earned and available to the broker until the service has been fully performed and the occupant leaves the premises. Under the "tax rule," such fees are earned when the broker has the right per contract to use the money received. Rule E-1(e)(6) applies the accounting rule, unless the parties agree otherwise. The management agreement and lease/reservation agreement must clearly and consistently disclose the nature of all fees and commissions charged to the parties concerned. Use of the "accounting rule" is a recommended approach. The delay between the date of check-in and the accounting cycle end date when actual proceeds checks are cut, gives the broker additional time to make adjustments for late bills from vendors and/or account for changes in services billed to guests, without borrowing from unearned advance deposits. The accounting rule is also illustrated by the general industry "guest cancellation policy" below. The time of a refundable cancellation may vary from 30 to 45 days before check-in, depending on the seasonal demand for the unit. The "tax rule" results in the deposit becoming non-refundable as early as upon receipt, but spending these amounts before the rental is used may create later hardships for the broker.

Rule E-1 (f) (6) also requires an accounting for any commissions and fees or other charges withdrawn in a single and usually "estimated lump-sum disbursement" from a management escrow bank account. Such an accounting must be shown by corresponding entries in the journal and the individual ledgers of those affected. The rule was adopted to prevent continuous guessing as to what amount is earned and payable to the broker; this approach follows "a one-sided journal entry," where no corresponding amounts are recorded in the individual owner ledgers. In companies where different commissions are charged to owners of different units, control over the accounting for earned commissions will soon be lost. The broker must be able to provide a schedule, upon request, which breaks down all components of the amounts included in any lump-sum disbursement. The schedule can be made by a "custom computer report" or manually prepared. The ledger entries must report such disbursements in accordance with Rule E-1(p)(2) and include the date or time period for each individual transaction, rental or occupancy. CRS 12-61-113(1)(g) requires the broker to account for any money belonging to others coming into the broker's possession; this includes money paid to the owner, tenant, guest, other vendors and service providers, and/or other governmental agencies, as well as the resulting commissions and fees paid. See Appendix Exhibit J.

The "Guest Cancellation Policy." These terms are generally found in the reservation agreement for rentals of short-term occupancies (30 days or less). The policy specifies when the prospective guest's advance deposit becomes non-refundable. By general industry practice, an advance deposit becomes non-refundable 30-45 days prior to the guest check-in date (depending on company policy and season in which the unit is rented). At that time the non-refundable deposit belongs to the owner and may only be withdrawn for any earned brokerage fees or commissions according to the management agreement. According to local custom, a travel agent fee may be deducted by the agent before the net amount is paid to the broker's company.

Short-term rentals do not currently require licensure as a real estate broker. But if the activity is conducted through a licensed brokerage, the licensee is not exempt from the jurisdiction of the commission, must maintain the escrow and record keeping requirements found in C.R.S. 12-61-113(1)(g), (g.5), (k) and Rule E-1, and the broker must account for commissions and fees earned according to Rule E-1(e)(6).

The following time line illustrates how to determine the unearned advance deposit liability on the date the account is reconciled based on the funds held "now" per the accounting equation:

$$\begin{aligned} \text{Now: All folios with check-in dates 30 to 45 days from now} \\ \text{Non-Refundable Period} = \\ \text{Liability for future guest deposits} = \\ \text{Cash in Escrow Now} \end{aligned}$$

Ownership of the Management Records and Business Termination. A broker who manages property and homeowner associations may receive requests from the owner or homeowner association for originals or copies of the escrow records. In such cases, the broker should follow the procedures below.

A licensed broker managing a common interest (homeowner) association, is generally the temporary custodian and trustee for the association records. Such records generally pertain to any budgeting, financial, or on-going administration of the association business and related operating policies, conducted by the broker pursuant to the management agreement. These records belong to the association, not the broker. Rule E-3 requires that all such records be promptly returned to the association upon termination of the broker's employment. A broker may retain file copies at the broker's own expense.

When there is a change in the managing entity employed by the property owner, the ownership of property management records and the cost of making requested copies might also become a point of conflict. The broker should anticipate and address this issue in the initial management agreement. There is no commission requirement mandating that the broker absorb the costs of any record duplication. An alternative process, such as inspection or audit by the

landlord or client during a "window period," might be more acceptable than billing a large sum for producing extensive duplicate copies. The broker may not use the requirement to keep escrow records as a reason to prevent furnishing adequate information or documentation concerning the performance of duties or representations made in the accounting reports upon request of the owner, new manager or association. The broker as a "custodian" of the information maintains on-going records, association-vendor contracts, assessment and collection records, legal actions, association bank accounts, and association accounting records. The records utilized for such management should be delivered to the owner upon termination of the employment.

It is recommended that the broker obtain an itemized receipt from any new manager, or the association board, stating they have received all records and accounts that were previously in the broker's custody. This statement should acknowledge the statutory requirement applicable to the broker for retention of these records for four years, and waive any claim against the broker for release of such records in the event of subsequent loss or destruction.

If the broker questions the certainty of obtaining records at a later time and no waiver is granted, the broker should copy the financial statements, independent audit reports and/or any minutes of meetings concerning key contractual duties performed or unresolved issues, the supporting bank statements and monthly reconciliations prepared, along with related management agreements, sample leases and/or occupancy agreements, and sample disclosures required by the Commission. Verification of reported receipts or expense is important to the Commission, the property owner, and other governmental entities. The broker's records, whether originals or copies, must provide a clear "paper trail" from the depositor to the authorized payee, and show "money belonging to others" was properly utilized for authorized purposes.

If the change of brokers is within a licensed entity, the departing broker should follow the guidelines found earlier in this chapter titled "Change of Employing Broker."

Required Disclosures. In addition to the lead-based paint and brokerage relationship disclosures required by Rules E-39 and F-19, Rule E-1 (o) (8) requires written disclosure and consent for any compensation for services billed to clients and customers. The broker must disclose the use of any affiliated business entity (including those owned by related parties) to provide services to property owners.

A broker may sometimes add administrative overhead, and/or other similar mark-up fees to a vendor's invoice as compensation for to arranging or overseeing the service. This increased amount may then be erroneously reported in the owner's accounting statement as if they are the "true" cost of the job charged by the vendor. The may result in a valid complaint over dishonest dealing. Similarly, use

of an affiliated or related business entity that does not have to compete for the job at "arms length" may have the same result. C.R.S. 6-1-105(1)(e)(I) provides for damages to an injured party in any civil litigation for deceptive trade practices.

To comply with Rule E-1(o)(8): First obtain prior written consent for payment of any additional compensation in the management agreement or a signed and dated addendum as the situation warrants. Next, disclose the fixed percentage of markup in these agreements and show the dollar amount added to the cost of the service rendered or provided in the owner's monthly or periodic accounting statement. This avoids any question about the client/customer's actual receipt of such disclosures by showing the added cost in the broker's own accounting report, rather than in a separate invoice attached to the report. If there are variable or unique rates and prices used, these should also be disclosed and pre-authorized in the management agreement or addendum. Additionally, disclose the use of any affiliated or controlled business entity providing such service, the billing rates used, and a general statement to the effect that the broker may or may not realize a profit in providing such services. Finally, maintain the internal accounting records, invoices and reports showing compliance with the terms of the agreement(s). Brokers are advised to review and update any old or outdated agreements and should consult with resources available from IREM, NARPM, BOMA, CAR, and their own attorney in this matter.

2) ACCOUNTING FOR SECURITY AND ADVANCE RENTAL DEPOSITS

Rule E-16 applies to all licensed brokers. The following requirements should be followed in residential and/or commercial property management. This rule states: "A broker receipting for security deposits shall not deliver such deposits to an owner without the tenant's written authorization in a lease or unless written notice has been given to the tenant by first class mail. Such notice must be given in a manner so that the tenant will know who is holding the security deposit and the specific requirements for the procedure in which the tenant may request return of the deposit. If a security deposit is delivered to an owner, the management agreement must place financial responsibility on the owner for its return, and in the event of a dispute over ownership of the deposit, must authorize disclosure by the broker to the tenant of the owner's true name and current mailing address. The broker shall not contract with the tenant to use the security deposit for the broker's own benefit."

The commission's position statement on Advance Rental and Security Deposits (Chapter 16) expounds on this rule. The goal is to have consistent terms for the responsibility to return any security deposit in both the lease and management agreement, or addenda thereto. These requirements are not met when the lease provides that the owner holds the deposit and the management agreement is silent on the matter. Such inconsistency may create an unfunded and undisclosed financial liability for the property owner. The broker must account for the return, forfeiture, or transfer of the tenant deposit per the requirements of C.R.S. 38-12-103(1), (2), and (4).

Local Requirements. Boulder currently requires payment of a stated rate of interest to tenants for any security deposits held for residential housing leased in that city. (See City Ordinance 4969, Title 12). The broker should inform the property owner of this requirement and may have to assess the owner for any difference between the "statutory rate" and the lower "market rate" of interest when accounting for return of the deposit upon termination of the lease.

Advance Deposits. Under the property management agreement, a broker must transfer all escrowed money belonging to the owner of the property at reasonable and agreed upon times with the accounting required by Rules E-1(p) or E-2. If such money is subject to recall by the guest/occupant, it must be escrowed until rightfully earned per Rule E-1(e)(6), and then must be transferred or credited to the property owner. A broker has no right to use an unearned advance deposit that is subject to recall. Deposits that are not subject to recall by the guest/occupant may not be transferred to the broker's business operating account, or used for the broker's benefit unless this is specifically authorized as an earned commission in the management agreement with the property owner. See the discussion found in "The Guest Cancellation Policy" above.

Offsetting Broker Expenses against Refundable Deposits. Questions arise over whether a broker may pay certain expenses from refundable deposit amounts held in trust. The answer depends on the ownership of these funds.

A broker has no ownership in earnest money held in a sales transaction. If the seller and broker terminate a listing agreement when the parties are unable to close a transaction, and the buyer is not in default, the broker may not use the deposit money to pay expenses that would have been due from the seller out of a later earned commission. The deposit must be returned to prospective buyer intact. If the buyer has forfeited the deposit, the broker isn't entitled to any of the earnest money unless there is a previous written agreement with the seller to share the amount forfeited. The provisions of the commission position statement on earnest money deposits (Chapter 16) should be followed when ownership of the deposit is disputed.

Similarly, the broker has no ownership interest in management funds held as refundable security or advance deposits. Lease and management agreements often allow the broker to collect and retain late fees, non-sufficient funds charges, and other fees from tenants. Such fees are for the benefit of the broker and Rule E-16 prohibits withholding such amounts from a refundable security deposit. C.R.S. 38-12-103 (1) provides that the deposit may be withheld for non-payment of rent, repair work, or cleaning contracted for by the tenant for the benefit of the property owner, not the broker. Section (7) of the foregoing statute also states that any provision in the rental agreement whereby any provision of Section 103 (1) is waived shall be deemed to be against public policy and shall be "void" (not legally binding).

The broker who holds a refundable deposit does so for the benefit of the owner and tenant. If the deposit is slowly liquidated to collect fees owed to the broker, the owner's security is jeopardized both by a loss of financial assurance against damage and by the tenant's loss of motivation to properly care for the property. Further, the owner could become fully liable for return of the full deposit (plus treble damages if paid late) even though the tenant might owe money for late fees and other charges to the broker.

If the broker has gained proper agreement for the collection of fees in both the management agreement and lease or occupancy agreement, then upon termination of the lease or occupancy, the order of deduction should be: first to the owner (for property damages, etc.) and then to the tenant less any late fees or other costs due the broker. If the balance is not adequate to pay the broker, the broker must seek collection directly from the tenant concerned. The concepts above also apply to brokers who receive advance short-term deposits. Care should be taken to insure all associates understand the proper handling of refundable deposits.

Office Policy Manuals. Commission Rule E-31 requires brokers to demonstrate reasonable supervision and training of staff in the licensed transactions conducted within their office. Brokers are required to establish an office policy manual when they employ others. This is in addition to the requirement for a written brokerage relationship policy (Rule E-39), whether performing sales or management activity. To comply with Rule E-31, the following topical guidelines (as applicable) for office policy manuals are suggested:

SALES TRANSACTIONS

- Parties responsible for delegated duties/agreements
- Preparation and review of contracts prior to closing
- Handling earnest money deposits, disputes and releases
- Backup contracts
- Closing documents and closing instructions for the broker's agent
- Maintenance/custody of contract files
- Escrow records and written procedures for handling business operations
- Fair housing/affirmative action marketing
- Staff training -- dissemination of information, staff meetings
- Use of personal assistants
- Guaranteed buyouts
- Investor purchases
- Non-qualifying assumptions and owner financing
- Licensee's purchase and sale of property
- Listing procedures and release of listings
- Rental occupancy before closing
- Computer system – data control, backup and physical security

- Internal audit and supervisory reviews of business operations

MANAGEMENT ACTIVITY

- Operating policies and required disclosures
- Administration of rentals and leasing activity
- Items under Sales above where applicable
- Supervision of accounting services, records and reporting to others
- Cash handling, collection of delinquent rents and deposits
- Ownership/management of rental properties by agents
- Administration and policies for in-house services
- Maintenance of records and business reports by any outside service
- Advances of funds on behalf of clients/customers
- Cancellation of agreements and termination of services
- Related services performed by affiliated entities
- Backup and disaster recovery plan for loss of business records
- Eviction and legal action
- Return of security and advance deposits

Accounting Problems to Avoid. The following list highlights some general but common audit problems found in management audits.

1. The software used reconciles to a "net" cash balance, where positive owner ledgers are offset against negative (overspend) balances with a resulting cash shortage. This may result from use of the accrual basis of accounting by "default" in the installation process, or by allowing payment of expenses in anticipation of future revenues. It is acceptable for the same owner of different properties to offset negative balance properties against other positive ones if the end result is positive.

2. Failing to print out the bank reconciliation in detail at the time the account is reconciled. Some software programs will not retroactively reproduce earlier reconciliations with the corresponding current liability detail. This weakens internal control and increases the difficulty of reconstructing prior records in the event of a system "crash." The reconciliation should be printed on the actual date of reconciliation, which is normally the same as the ending bank statement date. When Bookkeeping software (i.e., *Quickbooks*) is used, brokers may keep the escrow reports by month in yearly, tabulated notebook. The first section is the monthly ending journal balance (the monthly check register), the second section is the listing of pending ledgers at month end, the third is the monthly detail bank reconciliation printout, and the fourth is a copy of the escrow bank statement.

3. Using fictitious deposits in transit and/or outstanding checks to "plug" the reconciled bank balance on the reconciliation worksheet. "Plug" means to balance the reconciliation by using arbitrary or nonexistent items to force the reconciled bank balance to agree with company records. While this condition may be a simple fix, it may mask an on-going internal theft of funds in any bank

account. Brokers should inspect the items shown on the reconciliation worksheet carefully, and review the corresponding journal and ledgers before accepting the report as valid. Outstanding amounts should clear quickly. Fictitious "voids" are common tools used to conceal unauthorized account withdrawals.

4. Making "John Doe" deposits and/or payments without recording or maintaining appropriate supporting information in the accounting deposit/check records. This may be due to over-extended job duties or poor record keeping, but may also conceal serious errors or thefts of trust assets. This condition usually leads to complaints for failing to account for money belonging to others.

5. "We'll wait and fix that again in the next audit." C.R.S. 12-61-103 grants the broker's license on the basis of demonstrated competency to transact business in a manner, which protects the public interest. A repeated failure to correct audit conditions is contrary to the requirements of Rule E-30(f). The audit representation letter affirms the broker's agreement to maintain required corrections in place after the examination is completed. An "Audit Preparation Checklist" can be found in the Real Estate Commission's website, under "Publications".

PART FOUR - SUBDIVISIONS AND ASSOCIATIONS

General. This part describes the financial accounting requirements applicable to brokers and developers who list and/or market property registered with the commission as a subdivision. All brokers actively marketing these subdivisions must insure that the applicable provisions of rule E-1 are followed. Developer sales contracts and disclosure forms are individually approved during the subdivision registration process and must be used for the sale of a registered subdivision property. The form used by the developer should be studied and understood by the real estate broker. Developers, if not required to use licensed brokers under the exemptions found in C.R.S. 12-61-101(4), may still be subject to other accounting and record keeping requirements contained in any applicable sales, management agreement, the declaration and bylaws, the Subdivision Developers Act C.R.S. 12-61-405 (1) (e), (g), Commission Rules S-23(n) and S-36, and/or the Colorado Common Interest Ownership Act C.R.S. 38-33.3-101.

The goal of the regulatory process is to insure that there is reasonable disclosure of all material matters at time of the sale, and to insure that the purchaser's ownership interest in the land is conveyed according to the terms of the contract, free and clear of any overriding or superior encumbrances. Commission accounting requirements for developers differ in significant ways from those applicable to brokers. Rule S contains significantly fewer requirements than Rule E. The developer may also be subject to requirements under the Colorado Common Interest Ownership Act (CCIOA), C.R.S. 38-33.3-101.

Use of Licensed Brokers. Subdivision property registered in Colorado must be sold by actively licensed brokers, unless exempt under C.R.S. 12-61-101(4). In the absence of an agreement/contract to the contrary, brokers for these sales must escrow funds received in accordance with Rules E-1, E-1 (k), (l), and S-23 (i) and (j). The broker must account for and remit such money according to the sales contract and/or the employment agreement with the developer and/or association, and keep the applicable escrow records described in Part One of this chapter.

Subdivision Registration. Any agreement/contract for the sale or lease of property shall be voidable by the purchaser and unenforceable by the developer unless such developer was duly registered under the Subdivision Developers' Act at the time the contract was made.

Developers are required to register with the Commission if they market Colorado property to others, or if they sell out-of-state property in Colorado, which is: (1) divided (cumulatively) into twenty or more interests intended solely for residential use, (2) a conversion (cumulatively) of an existing structure into a common interest community of twenty or more residential units, (3) a group of twenty or more timeshares intended for residential use, or (4) a group of twenty or more proprietary leases in a cooperative housing corporation.

Registration is not required for: (1) selling memberships in campgrounds; (2) bulk sales between developers; (3) residential property not previously occupied which is to be constructed and where the consideration paid includes the cost of the residential building(s) or new home(s); (4) lots, which at the time of closing or lease, are situated on a street improved to the standards of those maintained by the county where the lot resides, and which have a feasible plan for water and sewage disposal, and which have phone, electric and utility services adequate to serve the lots under applicable city, county, state or federal laws; (5) any subdivision which is or has been required to be approved after September 1, 1972 by a regional, county or municipal planning authority. Questions may be directed to the licensing section (303)-894-2166 or (303)-894-2518.

The developer's registration expires on December 31 of each year, and a developer is not authorized to transact business after expiration. A registration that has expired may be reinstated within 2 years after such expiration upon payment of the renewal fee if the developer meets all other requirements of the developer's act.

Contract Provisions. All contracts used to market registered property must include the following (other disclosures are required by Rule S-23 in an attached disclosure document):

- The names of the licensed real estate office and broker responsible for making the sale.

- The purchaser's five day right of recession immediately above the purchaser's signature line.
- A statement that a title commitment and/or title insurance policy will be delivered, unless otherwise agreed, Rule S-23 (k), S-31 and S-32.
- A statement concerning the time for delivery of deed after closing or payment of all installment amounts due, Rule S-30.
- A statement of any taxes, special authority/district taxes, or assessments to which the purchaser may be subject, whether existing, proposed, or unpaid at the time of contracting, Rule S-23(f).
- Seller and landlord disclosure of lead-based paint hazards for housing built before 1978, Rule F-19. This HUD disclosure became effective September 6, 1996 for sales and rentals of more than 4 residential dwellings. There are severe penalties for non-disclosure. See the HUD pamphlet titled "Protect Your Family From Lead in Your Home".

ACCOUNTING REQUIREMENTS FOR REGISTERED DEVELOPERS

Commission Requirements for Sales and Leasing. Commission requirements are found in Rule S-36 and C.R.S.12-61-406(2.5)(b). Beginning in 1990, the following records must be retained by the developer for a period of four years:

(1) Rule S-36 (1) requires copies of the sales contract, lease agreement, financing agreement, settlement statements, title commitment/insurance policy, trust deed, escrow agreement, and other documents (disclosures) executed by the parties to effect the sale or transfer of any interest in the subdivision to purchasers be maintained at a Colorado place of business (or to reasonably produce such upon request). Brokers selling subdivision property must insure that settlement statements are accurate and must show that any applicable association dues, transfer taxes or other membership fees are properly prorated, or paid by the party as agreed in the contract, Rule S-23.

(2) Rule S-36 (2) requires a record showing the receipt and disbursement of any money or assets received or paid on behalf of any purchaser or similar association managed or "controlled" (through actual voting rights held) by the developer.

(3) Any commission-approved escrow agreement with an independent third party and the related receipt and disbursement records showing the transfer of funds received from potential purchasers of reservations in an uncompleted project or pending subdivision registration under such escrow agreement, C.R.S. 12-61-402 and Rule S-20. Brokers engaged in the sale of reservation agreements must also comply with escrow requirements as the designated trustee and independent third party. The developer may not directly or indirectly control the handling of funds by the escrow agent, control the process of maintaining records of the agent's account activities, or exercise any independent right of withdrawal over the funds held, apart from the commission-approved escrow agreement.

(4) Pursuant to C.R.S. 38-33.3-315, the "declarant/developer" shall pay all common expenses until the association makes a common expense assessment and shall pay assessments on unsold units according to the allocations as set forth in the declaration; the declarant alone is liable for all expenses in connection with real estate in the common interest community that is subject to "development rights," C.R.S. 38-33.3-307. The association shall keep financial records sufficient to enforce liens for unpaid assessments under C.R.S. 38-33.3-316 and minutes of official meetings and association activity required by the recorded declaration.

(5) In addition to the above the following requirements must be met under CCIOA, if applicable, when a developer transfers control to the association membership in accordance with C.R.S. 38-33.3-303(5), (6) and (9):

(a) Original or certified copies of the recorded declaration, articles of incorporation, bylaws, minutes book, and any rules and regulations which may have been promulgated.

(b) An accounting for all association funds, including audited financial statements with an accompanying opinion of an independent certified public accountant that the statements present fairly the financial position in accordance with generally accepted accounting principles or a disclaimer of such attestation. The developer shall pay the cost for examination of the association financial statements.

(c) All association funds and control thereof.

(d) Inventories of personal property represented by the developer to be the property of the association or which has been exclusively used in the operation and enjoyment of the common elements.

(e) Copies of plans and specifications used in the construction of improvements in the common interest community.

(f) All insurance policies then in enforce in which the unit owners, the association, its directors and officers are named as insured persons.

(g) Copies of any certificates of occupancy issued for improvements comprising the common interest community.

(h) Any other permits issued by governmental bodies applicable to the common interest community one year prior to transfer of control to the members of the community.

(i) Written warranties of contractors, suppliers and manufacturers still in force.

(j) A roster of owners and mortgagees, and their addresses and known telephone numbers.

(k) Employment contracts between the association and others.

(l) Any service contract between the association and its membership with others.

(m) For large, planned communities, copies of all recorded deeds and recorded or unrecorded leases evidencing rights in the community and its common elements.

Management of Common Interest Associations. The developer's record keeping duty is found in Rule S-36 (2), C.R.S. 12-61-405(e), and when applicable, C.R.S. Title 38, Article 33.3, Sections 115, 117, and 118. The commission has jurisdiction over the developer during the time it controls the financial operation of the association by actual voting membership on the association board of directors. After the developer has transferred control of the common interest association to the membership, the developer is governed by CCIOA.

Pooled bank accounts are not allowed for the management of any common interest owner (homeowner) association consisting of thirty (30) or more units under the provisions of C.R.S. 38-33.3-306(3). This law requires the use of "separate accounts" for each association and association reserve account, the presentation of an annual accounting for association activities and a financial statement prepared by the manager, a public or certified public accountant, and the maintenance of not less than \$50,000 in fidelity bond insurance (or more per bylaws) for the manager and others who perform management activities on behalf of the association. Brokers who manage associations in their licensed company accounts must use separate escrow accounts per Rule E-1.

Preexisting subdivisions. Accounting for developer-controlled subdivisions created in this state before July 1, 1992 (which haven't elected treatment under C.R.S. 38-33.3-118) is generally governed by the provisions of declaration and bylaws or the applicable sections of the Subdivision Act. During the period of control of the association, beginning in January 1990, and for 7 years thereafter, the developer must maintain annual records, which reasonably show that there was no diversion, conversion or failure to account for any association funds. See Rules S-36 and S-23 (n). C.R.S. 38-33.3-117(1) and (3), of the Colorado Common Interest Ownership Act (CCIOA), does not replace pre-existing bylaws in regard to: (a) the process for transfer of control to the association members (38-33.3-303), or (b) the requirement to keep separate association accounts for funds and reserves held by the developer as manager of 30 or more units (38-33.3-306). The bylaws will frequently require more detailed records for interim inspections by association members and to prepare audited financial statements for the period of management while the developer controlled the association.

New Subdivisions. For subdivisions created after July 1, 1992, or those electing treatment under CCIOA, the record keeping requirements of Rules S-23 (n) and S-36 are supplemented by CCIOA, including 38-33.3-306(3)(a). A developer who manages an association of 30 or more units must keep the records showing compliance with the following statutory requirements for a 7-year period beginning January 1990. Such records must be reasonably available for inspection by members of the association or the commission at the developer's and/or broker's Colorado business office and shall include:

- (1) The association bank accounts, monthly statements, and returned items according to C.R.S.38-33.3-306(3) for the operating funds and reserves belonging to each association. If the manager engaged is a licensed broker, then separate escrow accounts shall be used, unless there is another agreement or law to the contrary. It is recommended that written agreement between the association and manager specifically identify the nature and requirements of the accounts and records to be used.
- (2) Property, general liability, and fidelity insurance or bond (for 30 or more units), and/or proper notice to the owners of any cancellation or the unavailability of such insurance, C.R.S. 38-33.3-313.
- (3) The minutes for all association board meetings per the applicable bylaws, C.R.S. 38-33.3-308.
- (4) Records necessary for transfer of control to the association. See detailed itemization found in C.R.S. 38-33.3-303(9), and sections 314 through 317. These sections require accounting records for the proper dispossession of any surplus association funds, amounts of assessments collected and uncollected or delinquent, interest and penalties, liens filed, association minutes, and other related membership voting records.
- (5) Records for the payment of association dues assessed to the developer for all unsold units, intervals or lots by the prescribed due date.
- (6) Records for any amount billed to the association for services provided to the association and any expense incurred in rendering such services. Such matters must be disclosed in the renewal of the developer's registration and in the disclosures required by Rule S-23 (n).

EXHIBIT A – NOTICE OF ESCROW OR TRUST ACCOUNT

TO _____
(Name of Bank or Depository)

Pursuant to C.R.S. 12-61-103(7), I, _____
am the designated employing broker for _____

(Name of Licensed Real Estate Company)

Furthermore, pursuant to C.R.S. 12-61-113(1)(g.5), (k), Colorado Division of Real Estate Rule E-1, and Federal Deposit Insurance Corporation (FDIC) requirements, I am required to maintain a “escrow” or “trust” account with a bank or recognized depository in the State of Colorado for the purpose of holding money belonging to others. With regard to any account which is designated as an “escrow” or “trust” account, the said account(s) is/are maintained with you as a depository for money belonging persons other than myself or my brokerage company in my fiduciary capacity as a licensed Colorado real estate broker under the provisions of C.R.S. 12-61-103(7) and Rule E-1 (g).

DATED this _____ day of _____, 20_____

(Signature of Employing Broker)

ACKNOWLEDGEMENT OF RECEIPT

I, a duly authorized representative of _____,
the bank or depository identified above and acknowledge receipt of the above “NOTICE OF ESCROW OR TRUST ACCOUNT” on _____ day of _____, 20_____.

(Representative’s Signature and Title) Rev 4/00



**EXHIBIT C – THE BENEFICIARY AND BROKER LEDGER CARDS
FOR EACH BENEFICIARY (SALES/UNCLAIMED PROPERTY):**

BUYER _____ SELLER _____
 LISTING ADDRESS _____
 CLOSING DATE _____ LISTING _____

DATE	CHECK	DESCRIPTION	PAYMENT	DEPOSIT	BALANCE

FOR BROKER/COMPANY FUNDS IN ANY ACCOUNT:

BROKER / COMPANY LEDGER _____ CARD NO _____
 FOR _____ ESCROW ACCOUNT

DATE	CHECK	DESCRIPTION	PAYMENT	DEPOSIT	BALANCE

EXHIBIT H – OWNER’S CASH BASIS ACCOUNTING REPORT FORM

SUMMARY OF CHANGES IN ACCOUNT BALANCES AND PROPERTY INCOME AND EXPENSES PAID FOR THE PERIOD ENDING _____ 20 ____																																																											
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EXHIBIT I – CHANGE OF EMPLOYING BROKER AFFIDAVIT

CHANGE OF EMPLOYING BROKER AFFIDAVIT

I, _____, License No.

_____,
am the current employing broker for

—

I hereby affirm to the best of my current knowledge and belief that all escrow account and escrow account liabilities stated herein or incorporated by reference are a complete and accurate representation of all “money belonging to others,” as defined in Commission Rule E-1(g), which is held or controlled by me in my fiduciary capacity as the company’s employing broker on this _____ day of _____ 20____. The escrow bank accounts listed below or as incorporated by reference are fully funded for all corresponding escrow liabilities incurred on the above date. The funds held in the escrow account(s) listed below are hereby transferred to the new employing broker and/or the continuing company officer(s) and/or director(s), with all corresponding escrow records and transaction files required by C.R.S 12-61-113(1)(g),(g.5),(k) and Rule E-1:

<u>Bank</u>	<u>Account Number</u>	<u>Purpose</u>	<u>Reconciled Balance</u>
<u>(Date)</u>			

The foregoing records, accounts, and cash balances are accepted as complete and accurate in all material respects by the undersigned parties, who release the departing broker from further obligation for the maintenance, custody, and the duty to account for new deposits, payments and banking events after the said date above. The undersigned parties agree to maintain the records received for the time required under C.R.S. 12-61-113(1)(i) at the licensed business location or company’s storage facility.

Executed this _____ day of _____ 20 _____,

by:

_____, License No _____,

Departing Employing Broker

and:

_____, License No _____,

New Employing Broker,

and/or by:

Officers and Directors (of the continuing company)

Rev 4/00