



Arizona Department of Real Estate (ADRE)
Auditing and Investigation Division

www.azre.gov

2910 N. 44th Street, Suite 100, Phoenix, AZ 85018

DOUGLAS A. DUCEY
GOVERNOR

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COMMISSIONER

Auditing & Investigations Definitions

Automatic Renewal Provision (A.R.S. § 32-2173 (A)(2)(a))

A property management agreement may contain an automatic renewal provision, if the property management firm sends the owner a reminder notice at least thirty days before the renewal date. If the property management agreement renews on a month-to-month basis, the property management firm must send a reminder notice at least every thirty days before the renewal date until a new agreement is signed.

Accrual Based Accounting

Under *the accrual basis*, revenues and expenses are recorded when they are earned, regardless of when the money is actually received or paid.

- 1) This method is more commonly used than the cash method. The accrual basis gives a realistic idea of income and expenses during a period of time, therefore providing a long-term picture of the business that cash accounting does not provide. However, accrual accounting does not provide any awareness of cash flow; a business can appear to be very profitable while in reality the bank accounts are empty.
- 2) Accrual based accounting without careful monitoring of cash flow can have potentially devastating consequences.

Available/Adjusted Balance

Available/adjusted balance is a bank account balance of *funds actually available* on a given day. The available/adjusted balance is determined by taking the cleared balance (defined below), adding uncleared deposits and subtracting uncleared checks and withdrawals. The available/adjusted balance and cleared balance will only be the same if there are no outstanding/uncleared items.

When reconciling a trust account, always use the available/adjusted balance.

Bank Account Reconciliation

A bank account reconciliation is an analysis that determines the adjusted bank balance, which is the actual funds available in a bank account. A bank account reconciliation is generally performed at the end of the month to correspond with the closing date of the bank statement.

To perform a bank account reconciliation:

- First, the adjusted bank balance is determined by subtracting uncleared debits (checks and other withdrawals) and adding uncleared deposits to the bank statement's ending balance.



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- Second, the adjusted bank balance is compared to the amount shown in the broker's receipts & disbursements journal.
- These amounts should be the same.

The adjusted bank balance is also used in the trust account reconciliation to determine if there is enough money in the account to cover the liabilities (obligations) of the trust account. *See Trust Account Reconciliation.*

Cash Based Accounting

The *cash basis of accounting* recognizes revenues when cash is received, and expenses when they are paid.

- 1) This method does not recognize accounts receivable or accounts payable. Many small businesses opt to use the cash basis of accounting because it is simple to maintain, it is easy to determine when the transaction has occurred (the money is in the bank or out of the bank), and there is no need to track receivables or payables.
- 2) The cash method is also beneficial in tracking how much cash the business actually has at any given time; your bank balance will show the exact resources at your disposal.
- 3) Also, since transactions are not recorded until the cash is received or paid, the income is not taxed until it's in the bank.

Client Ledger Balance (A.R.S. § 32-2151 (B)(2)) (Historical Balance Report, Owner's Statement)

Client Ledger Balance is a listing by owner name or property address that generally includes:

- Amount of owner funds in the trust bank account.
- Amount of desired reserves per the PMA.
- Amount of security deposit in the trust bank accounts.
- Total of owner funds and security deposits.
- May also include columns for pre-paid rents, other deposits, etc.

The client ledger can be produced by various Property Management software programs, have many names including, Historical Portfolio Balance, Portfolio Balance, and Bank Balance Breakdown.

Check Register

See Receipts & Disbursements Journal.

Chronological Log (A.R.S. § 32-2151.01 (E), A.R.S. § 32-2151.01 (A))

A consecutively (with no breaks in numbering) numbered log that lists all transactions of a brokerage, including real estate purchase contracts, lease agreements, and listing agreements (including cancelled, terminated and expired transactions). The transaction may be recorded in one log or there may be separate logs for each transaction type. These records must be kept for five (5) years after the date of the transaction.



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Cleared Balance

A cleared balance is a bank account balance that includes all deposits, checks and withdrawals that have already cleared the bank. The ending balance on the bank statement is the cleared balance as of the date of the statement.

Commingled Funds (A.R.S. § 32-2153 (A)(16))

Commingling occurs when a broker mixes his own funds with funds that he holds on behalf of a client(s). Commingling can occur by placing broker monies into a client trust account, or by placing client funds into a brokerage operating or other any non-trust type account.

Converted Funds (A.R.S. § 32-2153 (A)(16))

Conversion of funds occurs when a broker uses monies that are held in trust for clients for his own purposes, including, for example, paying general business expenses. A broker may transfer earned fees and some other funds from a trust account to the brokerage operating account as long as they are recorded on the Owner's Statements and Client Ledger.

Commission Account

A bank account, held by a Broker, into which earned commissions are deposited and then paid to agents. There is no requirement that a broker have a commission account or that such an account be designated a trust account.

Compensation (A.R.S. § 32-2101(16))

"Compensation" means any fee, commission, salary, money or other valuable consideration for services rendered or to be rendered, as well as the promise of consideration whether contingent or not.

Closing Statement (ARS 32-2151-01, A.A.C. R4-28-101, ADRE Advisory #5)

Closing is defined in the Commissioner's rules as "the final step of a real estate transaction, such as when the consideration is paid, all documents relating to the transaction are executed and recorded, or the deed is delivered or placed in escrow." A.A.C. R4-28-101.

The broker is required to keep records, including a complete copy of the sales contract, any escrow account receipt (including earnest money deposits), any closing or settlement statement, and, if applicable, a copy of the escrow instructions, listing agreement (if the listing broker), the employment agreement (with the brokerage), and release of escrow monies. A.R.S. § 32-2151.01(F)(2). Transaction statements are also required under A.A.C. R4-28-802 (C). The broker must also retain true copies of all receipts and disbursements, or copies of the executed and delivered escrow closing statements that evidence all



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receipts and disbursements in the transaction. Closing Statements should be signed by all parties to the transaction. These records must be kept for five (5) years.

The CFPB-TRID Closing Disclosure (CD) form does comply with the above and should not be held in the Designated Broker's sales transaction folder as the Closing Statement. A final Closing Statement per the Arizona Statutes and Rule must be included in the Designated Brokers closed transaction file.

Depository Outside State of Arizona (A.R.S. § 32-2151 (C))

A broker may place monies entrusted to him/her in a depository located outside of Arizona if all parties to the transaction agree in writing that:

- The monies are placed in a property management trust account established pursuant to 32-2174, the account is federally insured/guaranteed, the property management agreement contains disclosures that the Department's regulatory protections may be significantly hampered and that the owner may not have access to or any control over the trust account except to audit and review the status of the account, and an addendum that the signed authorization by an appropriately empowered official of the depository stating that all related documentation to the trust account will be open to examination by the Department or the owner, or
- If the monies are not placed in a property management trust account, the broker must disclose to the parties that potential risks may accrue as the result of depositing the monies in a depository outside this state.

Earnest Money (A.R.S. § 32-2151.01 (A))

Money paid by a potential home buyer, used when making an offer for purchase of a home. This money will be used toward the down payment and closing costs if the home purchase is completed. Earnest money informs seller that the buyer is committed to the transaction, as this money may be retained by the seller if the buyer backs out of the contract for a reason other than provided for in the contract.

A broker must keep earnest money receipts in order to confirm that earnest money was handled in accordance with the transaction.

Electronic Records

See off-site storage location below.

Employment Records (A.R.S. § 32-2151.01 (A) and (H), Substantive Policy 2005.06)

A broker shall keep employment records, including:

- Copies of employment status for all current and former employees and licensees of the brokerage, and
- If applicable, employment agreements.



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A broker may retain employment files by electronic means as long as all of the following conditions are met:

- The records are maintained in a manner allowing reconstruction in the event of destruction of electronic data.
- The records can be produced, at the broker's expense, in legible written form upon request by the Commissioner, or the Commissioner's representative, for auditing, inspection, or investigation purposes.
- The electronic records are exact duplicates of the original.
- The stored records are legible.

A broker does not have to keep an employment file on:

- himself/herself,
- non-licensed independent contractors, such as bookkeepers, accountants, or maintenance staff.
- Other member/managers of the corporation (owners of the business).

Escrow Account

This is a type of trust account held by a broker, which holds earnest monies in trust for clients. *See Earnest Money.*

Finder Fee (A.R.S. § 32-2176, § 32-2121 (A)(6))

A property management firm or property owner may pay a finder fee to an unlicensed person who is a tenant in an apartment complex managed by the firm or owned by the owner and may also authorize a residential leasing agent or manager to deliver the finder fee to that tenant.

A residential leasing agent or on-site manager may not receive a finder fee, but may receive a bonus that is:

- Based on performance,
- Received no more frequently than monthly, and
- Does not exceed one-half of the agent's or on-site manager's total compensation for the time period

Residential Leasing Agents or On-site Managers are natural persons employed by the owner or the owner's licensed management agent whose normal duties and responsibilities include any one or a combination of the following:

- Preparing and presenting to any person a residential lease, application or renewal or any amendment of the lease.



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- Collecting or receiving a security deposit, a rental payment or any related payment for delivery to and made payable to a property, a property manager, an owner or the location.
- Showing a residential rental unit to any prospective tenant.
- Executing residential leases or rental agreements adopted under title 33, chapter 10.
- Acting on behalf of the owner or the owner's licensed management agent to deliver notice pursuant to title 12, chapter 8 and title 33, chapters 10 and 11.

Generally Accepted Accounting Principles (A.R.S. § 32-2151 (B)(2))

A broker records must be kept according to generally accepted accounting principles (GAAP). GAAP includes:

- Basic accounting principles and guidelines,
- Detailed rules and standards issued by the Financial Accounting Standards Board (FASB) and its predecessor the Accounting Principles Boards (APB), and
- Generally accepted industry practices.

Off-site Storage Location (A.R.S. § 32-2151 (B)(2), § 32-2151.01 (A), 32-2175 (A), and 32-2196.06 (B)) (electronic records)

If keeping records at an off-site storage location, a broker is required to provide the Department prior written notification of the street address of the off-site storage location. When the address is changed the Department must be notified within 10 days.

Operating Account

The operating account is used by the brokerage to pay operating (business) expenses of the brokerage. Operating expenses include, but are not limited to, office rent, salaries, advertising, office equipment, and office supplies. Commissions paid to licenses of the brokerage and other brokerages may also be paid from the operating account.

Owner's (Client's) Account

A bank account established by a Broker for the owner of one or more properties managed by the Brokerage. An owner (client) may be an individual or a corporation/LLC.

Owner Reserve

The owner reserve is a set amount of owner money the broker desires to hold "in reserve" for emergency repairs and other purposes. The amount is set forth in the property management agreement. There is no statutory requirement that the broker always have that amount in the trust account.

Owner's Statement (A.R.S. § 32-2175(C))

An Owner's Statement is a record that is produced in accordance with the property management agreement between the Broker and the Owner of the Property. It is usually produced monthly, but can be



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produced quarterly or annually. It records all rents received (gross receipts), and expenditures, which includes maintenance, repairs, taxes etc., management fees to the broker, and payments to the owner. Owner statement may, but usually does not, include security deposits held.

Owner's Statements can be produced either on a property by property basis or by owner, since some owners own multiple properties.

Most Owner's Statements include the month end balance being retained in the broker's trust account for that particular owner (or property), but this is not required.

Proof of Deposit (ARS 32-2151(B)) (Deposit slips, electronic transfers)

A broker must keep documentation for each trust account showing proof of deposit or electronic transfer, which identifies:

- The transaction date,
- The amount of the transaction, and
- The names of the parties involved in the transaction.

Property Management Firm (A.R.S. § 32-2171)

A property management firm means any corporation, partnership, or limited liability company licensed pursuant to section 32-2125 (A) or a designated broker that by written agreement, manages rental property or properties for compensation.

**Receipts & Disbursement Journal (A.R.S. § 32-2151 (B)(2) and § 32-2175 (C))
(Cash receipts and disbursement journal, checkbook register)**

A receipts and disbursement journal is a record of all money received and disbursed from a particular account. It is a record of the deposits, receipts, and disbursements (which includes checks written and transfers out of the account) and provides an ongoing balance for the account.

The receipts and disbursement journal should identify/contain:

- The date of the transaction,
- The payer or payee,
- A check or transaction number,
- The amount of money,
- Reason or GL account involved.

ADRE Auditors review the journal for several reasons:



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- To compare the month end balance with the reconciled bank account balance.
- To determine if there are any uncleared items for bank account reconciliation or to verify entries on the Bank Account Reconciliation Report (provided by Broker).
- To determine if any of the deposits, receipts, or disbursements are in violation of statute or paid to common ownership entities.

Record Retention (A.R.S. § 32-2151.01 (A), § 32-2175 (A), (C))

A brokerage/property management firm must maintain

- For at least 5 years from the date of termination of the transaction of employment:
 - Records of each transaction
 - Earnest money receipts confirming that earnest money has been handled in accordance with the transaction,
 - Closing statements showing all receipts, Disbursements and adjustments,
 - Sales contracts
 - If applicable copies of employment agreements (listing agreement).
 - Employment records.
- Residential leases for 1 year after termination or until turned over to the owner or owner's broker.
- Property management financial records pertaining to clients for at least 3 years from the date each document was executed.
 - Bank statements,
 - canceled checks or bank generated check images,
 - deposit slips,
 - bank receipts,
 - receipts and disbursement journals,
 - owner statements,
 - client ledgers, and
 - applicable bills, invoices and statements.

Tenant Ledger (Rent Roll)

A monthly detailed record of all tenants, which includes:

- The name of each tenant
- The address of the property each tenant resides in, and
- All rents received or paid by that tenant.

A tenant ledger is used by the ADRE auditor to determine how much tenant funds a broker is keeping on deposit in a specified trust account.



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Trust Account (A.R.S. § 32-2151 (A) and § 32-2174 (C))

A fiduciary account set up by a brokerage which holds funds that belong to another party. In a brokerage, a trust account may be set up for sales/escrow purposes or for property management purposes. A trust account set up for a property management firm must have descriptive wording in the account title, such as:

- Trust account
- Fiduciary account (sometimes titled For the Benefit of individual or entity name)
- In trust for (individual or entity name) abbreviated ITF
- Trustee for (individual or entity name)
- Fiduciary for (individual or entity name)

Brokers can hold in trust monies belonging to:

- Tenants – security deposits, other refundable deposits, pre-paid rents
- Owners – reserves and undistributed income.
- Home Buyers – earnest money.

Trust Account Reconciliation to the Client Ledger Balances (A.R.S. § 32-2151 (B)(2)) (3-way Reconciliation)

A trust account reconciliation is a three step process:

- Reconcile the receipts & disbursement journal with the monthly bank statement (adjusted bank balance). This will determine the amount of funds available in the account and disclose any errors by the broker or the bank.
- Determine the amount of trust funds that are held for beneficiaries as of the date of the bank statement (trust account records). These should be readily available and up-to-date in the broker's tenant and client ledgers.
 - For Tenants, this will include security deposits, other refundable deposits, and pre-paid rents.
 - For Owner's, this will include any reserve amount held and undistributed payments due to the owner. Use only positive balances to offset the broker's liabilities.
 - Other liabilities may include property taxes and transaction privilege taxes etc. that have been collected but not yet paid.
- Reconcile the adjusted bank balance from step one with the trust account records in step two. The adjusted bank balance should equal or exceed (by not more than \$3,000.00) the total of the trust account records. Note: a trust account for a single owner or property that contains no broker funds can have a balance greater than \$3000.00.

If a broker maintains one trust bank account and one ledger for tenant and owner funds, the broker will perform one trust account reconciliation. However, if a broker maintains separate trust account records for tenant and client funds, the broker will perform two reconciliations.



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Sales/Property Management/Lease Logs (ARS § 32-2151-01)

See Chronological Log.

Signature Cards (A.R.S. § 32-2151 (A) and § 32-2174 (C))

A signature card is a document that a bank keeps on file with the signatures of all the authorized parties on that account. The signature card must have the broker's EIN number, the name and signature of each authorized signor, the business name or broker's name, and the show that the account was set up using the terminology required for a trust account. *See Trust Account.*

Unlicensed Natural Person (A.R.S. § 32-2174 (C))

A broker for a property may authorize an unlicensed natural person in the direct employ of the broker to transfer monies or to be a signatory on the property management firm's trust accounts. This person must be a bona fide officer, member, principal or employee of the property management firm. The broker is still ultimately responsible for all monies handled.

Voided Check

A voided check is a check that has the wording VOID written over the check. All voided checks must be retained. Voided checks are also reviewed for a number of verification reasons during an audit. Voided checks are usually used to verify:

- The account numbers of the various accounts held by a broker, and
- The name of the accounts (trust accounts should include "trust" or "fiduciary" in the title).