NARPM™

National Association of Residential Property Managers

Accounting Standards

Financial Controls Guide

Financial Controls for Property Management Professionals

Purpose

The NARPM® Accounting Standards Financial Controls Guide is designed to help you, the broker/owner, understand how to maintain financial controls that support a strong business and protect against fraud, errors, and audit risk. This guide is not designed to be a detailed manual on how to perform reconciliations, use specific accounting software, or achieve total compliance with your state regulations.

About the Authors

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About ProfitCoach: We fuel entrepreneurial freedom by growing broker/owner profits through authoritative PM accounting practices & services, definitive PM finance benchmarks, real-time metrics dashboards, and PM-specialized CFO coaching. For more information about ProfitCoach, please visit: www.PMProfitCoach.com.

Acknowledgements

This guide would not have been possible without the input, experience, feedback, and encouragement of many people. We are very grateful for the contributions of the following people.

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Introduction

Some property management audits are worse than others. Like the time when state auditors confronted Eric[1] with a deficit of over $115,000* in his security deposit account. Eric, shocked and confused, called an investigative property management consultant. "I just need to survive this audit without losing my license," he told her. "Can you figure out what's going on?"

After several days of reviewing the bank statements and the software records, and talking to members of the staff, the consultant had an answer—and it wasn't good.

"Here's what's been happening," she told Eric.

"Let's say Jacob moves into one of your units and pays you a $1000 security deposit. Your client requests to hold the security deposit, so you send it to him. You don't have that money now.

"But the client has to make extra repairs from the last tenant. He tells you to use the $1000 deposit for move-in repairs. So your internal maintenance company does the repairs, sends the bills to the management company, and gets paid—from the security deposit account. Remember, that money isn't there. You already sent it to the client. Now you've spent the deposit twice.

"Eventually Jacob moves out of the unit. Several months later, Jacob walks into the office and complains that his security deposit was never refunded. The person at the front desk reviews the tenant ledger to see if a check has been issued. If not, she writes Jacob a check for $1000 and stamps it with the company's signature. Now you've spent the deposit three times.

"This has gone on for three years," said the consultant, "and, honestly, this is the worst case I've seen in my career."

Eric sat there for a while, trying to make sense of the tangle. "So... what do I do now?" he asked finally. "I hired you to save my license. Tell me how to get out of this."

The consultant shook her head. "I'm sorry," she said, "but unless you can put $115,000 back in that account, there's not much to do. That money is gone. And according to the bank statements, most of it has gone to your internal maintenance company. The auditors have every reason to think you've been taking money that wasn't yours. We can explain the confusion, but I can't guarantee they'll be convinced."

1 Name and numbers changed to protect privacy.

This is a property manager's nightmare. You may have worried about something similar happening to your business. Perhaps you've experienced this yourself. But even if you've never given it a thought, it's past time to start caring about your accounting beyond a net income or cash balance review.

A business falls into serious trouble when the broker/owner doesn't review and understand financial reports. And to be honest, most broker/owners have never been given the tools to understand financial reports, especially when it comes to property management. How much training in property management did you receive while preparing to obtain your real estate license? Probably not much, and probably not in any detail. Our goal is to help fill that gap.

Don't think that you're "not a numbers person" and turn all financial responsibility over to Jeremy. As we'll see, this opens the door for an avalanche of errors—and for opportunities for Jeremy to sneak some of those numbers out the back door. You need to keep a finger on the financial pulse of your business. And the good news? **You don't need to be an accounting expert to do that.**

When you understand these key financial pieces, you can avoid nightmare situations. But you'll also find real financial benefit from following this guide. You'll be in a better position to make strategic financial decisions with confidence because you know where you stand. You may even see your bottom line improve as you tighten controls on your revenue.

Not convinced yet? Let's take a tour through some common scenarios that have resulted from capable operators who weren't careful to oversee their finance and accounting functions.

Client Turnover

Bob* managed about 300 units with the help of his assistant, Lori*. With both of them logging twelve-hour days, they made everything work—except for the bookkeeping. At one point they switched to a new software system to help keep track of the business, but they were too busy to learn to properly use the software and understand its reports. Clients complained that their rental statements were often incomplete, and that the money they received didn't match their statement. Neither Bob nor Lori could explain to clients why there was a discrepancy. Two clients (and 17 units) walked away.

Another unit was in need of major roof repairs. The client/owner was traveling and out of reach for a while, but Bob finally made contact, only to discover that the client had given him ten thousand dollars to start the roof repairs—a full month ago. Bob hadn't realized that the money had already come in. Not happy with the apparent lack of record-keeping, the client gave notice that he would leave, with his 15 units, at the end of his lease.

Over-Collecting Revenue

By Software Quirks

Jane* used an old property management software platform for years. Whenever an additional fee was charged, she had to enter it manually. When she finally switched to an updated software, she didn't realize that the system automatically calculated certain fees, like late fees. So she continued to enter the fees manually—double-charging the tenant.

Section 8 Billing Mistakes

In this instance, the original problem lay with the housing authority, but the management company handled it in the wrong way. The housing authority overpaid by $200 per month for several months in a row. The management company, rather than holding the overpayment as a liability, continued to send the full amount to the client. When the agency finally revised their billing and clawed back the money, that client was no longer under management. The agency deducted the overpayment from another client, leaving that client with hundreds of dollars less in Section 8 contribution than they should have had. So the management company had to chase down the old client to untangle the issue.

Under-Collecting Revenue

By Forfeiting Management Fees

One property manager agreed to let the client hold his tenant security deposits, equivalent to one month's rent. The client, though, treated the deposit as the "last month's rent." The tenant was told not to pay rent on the last month of the lease because it had been prepaid by the security deposit. This way, no management fees were taken out of the last month's rent and the client kept the whole payment. Since the property manager didn't enforce the management contract, this became the client's standard practice.

Under-Collecting the Fees You Agreed to Collect

At another property management company, the data entry clerk would enter a new client in the software but would often forget to enter the management fee percentage. Since the company didn't regularly review their fees, they frequently failed to collect management fees. They had to call one new client and explain that they had failed to collect the first five months' worth of management fees. Needless to say, client relations did not improve.

Failing to Apply Prepayments

Usually this is a software issue. If a tenant prepays his rent, the prepayment should be booked as a liability until the effective rent period. Some softwares will automatically apply the prepaid rent in the correct month and turn it over to income. But some softwares don't. If the software never applies the prepaid rent as income in the relevant month, the software will never charge the applicable management fees on that prepaid rent.

Fraud

Geri,* the accounting manager for a property management company, had a streamlined process for collecting rent from lower-value units. When the property managers were sent out to the units to collect the rent, she gave them each a deposit slip to fill out and told them to deposit the money in the bank on the way back to the office. The property managers brought her back the deposit receipts for documentation. The operation ran quite smoothly until the business was audited and found to be nearly half a million dollars upside down. Geri had been handing the property managers deposit slips for her personal account, not the business account. The broker had had no idea that the money was missing. By the time the theft was uncovered, they had no option but to shut down the company.

Other Accounting/Software Issues

Not Using the Software

One property manager didn't want to use his property management software as part of his routine. He wanted the reports but he didn't want to take time to keep the software regularly updated. His third-party accountant tried to enter everything into the software after the fact, but he would often forget crucial details—who paid him? When did they pay him? Was that the tenant who overpaid? Without consistent and accurate records, he constantly ran the risk of losing money, not to mention losing clients.

Not Reconciling the Books

For ten years, Luke* managed a high-value rental property. He mailed monthly checks to the owners but didn't communicate with them beyond that. After an accountant realized that the bank balance was six figures higher than it ought to be, they finally reconciled their accounts and found that the checks from the past seven years had never cleared. An informal investigation revealed that those clients had moved away without leaving a forwarding address. Luke tried to locate their new address but never could find them.

The accountant advised that the money had to be surrendered to the state as unclaimed property, so Luke sent most of it to the state. But he kept back over $20,000 as a buffer in his trust account, which put him at a high audit risk. No state tolerates that amount of broker funds in a trust account.

Okay, I care!
What am I supposed to do?

Ready to learn how to avoid these common and sometimes deadly issues? We'll start by looking at a broad overview of what you need to know to survive (in Part 2). Then we'll dive further into the details (in Parts 3 & 4).

Conversation Roadmap

So Where Do You Go from Here?

Whether you think you're doing pretty well, or whether you know you're in big trouble, the first step is to gain clarity on where you're at. Nail down what the problems are. Identify the deficits. Then you can start finding ways to move forward.

At the end of each section we've included questions you can take to your professional advisors (accountant, consultant, etc.) or to your team members. These questions should help you gain clarity on your current position and open up new angles to consider.

Sample Conversation Starters

Advisors

- What questions should I be asking about my current financial situation and any risks I may be exposed to?
- Can you tell me if my trust accounts are properly reconciled?
- My clients always complain about X on their statements. What process can I implement to prevent that issue?
- If I were to be audited today, what do you see as my most serious issue?

Team Members

- What do you see as our biggest financial problem or risk?
- What do you find is YOUR biggest difficulty in your role?
- What client or tenant complaints do you hear over and over?

Part 2—Essential Broker/Owner Responsibilities

As the owner of a property management business, you have a million items on your to-do list. This section will boil down the essentials of what you need to KNOW, DO, MANAGE, and MONITOR to successfully handle your finances without adding bookkeeping to your list.

Here's What You Need to Know

You Need To Know: The Big Idea—Trust Accounting

This is the mindset of handling someone else's money—in many cases, dozens or hundreds of people's money. Each client is watching you. The state is watching you. You need to get this right.

Here's the central idea:

Every Property Is Its Own Business

Not just every client, but every property.[1] Every address. You need to track income and expenses separately for each property in its own general ledger, even if two or more are owned by the same client. You need to handle money separately for each property.

But you may not have separate bank accounts for each property. You likely have a trust account that handles the money for all properties at once. And this is where things can get mixed up. **Even if all clients' funds are in the same account, there are invisible walls holding them in separate compartments. You need to keep those walls strong and unbreakable.**

It's as if you're overseeing 175 separate bank accounts, even if you have only one actual account. On your end, in your property management software, you need to be able to know the breakdown of all 175 separate accounts. *Of the money in the trust account, how much of it belongs to Property A and how much to Property Q?* If you've run out of money for Property Q, you can't take money out of Property A (unless they're owned by the same client—and even then, some states require the client's explicit permission for that transfer). Their money must remain as separate as if it were in a different bank account. Generally, you shouldn't take any property negative. Every property balance must have enough money to cover any liabilities against that property.

The same idea applies to handling tenant money, specifically security deposits. It's a little easier if you have a separate account for holding security deposits. We'll cover that in more detail in Part 4.

You Need To Know: The Rules

Rules Common to All States

- Do not maintain broker funds in the trust account.
    - See Part 4 for more details.
- Keep detailed reconciliation records.
    - See Part 3 for a discussion of reconciliation, including documentation requirements.
- Keep a paper trail on all trust account transactions.

1 This can actually vary with your state and your software. Some states require you to operate on a property basis, while most states allow for trust accounting on an owner basis (e.g. each client is its own business). Most softwares allow you to run a report where you can see both property and owner balances. No matter your state requirements, however, if you think through trust accounting in property-based terms, it can clarify the nature of the business.

    - See the "Trust accounting" section under "Routine Processes" in Part 4.

Your State's Regulatory Climate and Any Strict or Unusual Requirements

Each state has slightly different rules.

- California requires that all records be retained for 3 years, while Oregon requires that all records be retained for 6 years.
- Missouri allows up to $1000 of broker funds in the trust account to cover bank fees, while North Carolina allows only up to $100.
- Some states require that you pay interest on security deposits.

Know what your state requires for trust accounting. We'll provide you with a list of potential regulations in Part 4.

You Need To Know: The Risk

What happens if you don't really want to mess with all this?

Short answer: Any of the scenarios described in Part 1. And others.

All small businesses need to pay attention to their finances, but **most businesses don't carry the same level of risk that a property management company faces daily.** Even a small property management enterprise can manage staggering sums of money in a month or a year, and most of it belongs to other people or entities. Simply put, you have a lot more to lose, both in money and in reputation, than the neighborhood café.

Trust accounting rules may feel overly technical, but they are your best safeguard against fraud. Many thefts are discovered—and many could have been prevented—by tightening up the business processes to follow general accounting standards. And honestly, it can be a huge competitive advantage if you take the time to get this right. Many clients have horror stories of property managers who didn't handle the finances correctly, and they will love having a property manager they can trust to get it right.

Sometimes the state rules may feel burdensome and unnecessary. Sometimes they might be. But as a property manager who holds many other people's money in trust, you can build a perception of trustworthiness by following the rules for handling that money. You put yourself and your clients and their tenants at risk if you do not structure your business according to the rules.

We promise, you don't want to find yourself on the published list of property management companies disciplined by the state. Nor do you want to be faced with five or six figures missing from your trust account that you'll have to replenish.

Now that you KNOW all this...

Here's What You Need to Do

These are the things that you as the broker/owner need to take seriously. You can collaborate with other team members, but you should avoid delegating these responsibilities.

Establish and Review Internal Controls

Internal controls are the processes that focus on preventing intentional problems, like fraud or theft.

The most important internal control is segregation of duties. That is, make sure that no one person has access to siphon off funds from the business, perhaps by writing themselves a check or helping themselves to some of the deposit money on the way to the bank. We'll have more detailed suggestions in Part 4.

Establish, Document, and Enforce Clean and Thorough Processes

One of the most effective ways to bring your business out of chaos, to make employees, clients, and yourself (and the state) happy with your business, is to set down in writing how you want your business to be run. Write out a process for each crucial task of the business.

This documentation will give you something with which to train your employees and to check up on them, to be sure that all clients are treated the same and all situations handled correctly. Your employees will thank you for clarifying what they should be doing. Your clients will thank you for your consistency. The state will thank you for keeping things straight (okay, maybe not). And you will thank yourself for giving yourself a way to understand all the pieces of what's going on.

Here are some key areas to consider when you begin to write up processes (more detail in part 4):

- **Onboarding Clients and Vendors**
  As in any relationship, the first impression you make is key. Your onboarding process should both gather all necessary information and make a strong first impression. Design your onboarding processes to be smooth, thorough, professional, and timely, and also to give an idea of your business's personality.
- **Office Management**
  Where should the receptionist place the checks she receives? How often should bank deposits be made? How often should checks be cut for vendors? Do you have a standard way to handle irate tenants who walk in? Identify the points at which your business tends to lose track of what's going on, and design a process to standardize those points. This will reduce the possibility of errors and make it much easier to track down any discrepancies in your records.
- **Financial/Accounting Workflow**
  You don't need to be an accountant, but you do need to have a general idea of the flow in your finance department. How often are the records being updated? How often are the banks reconciled? What's the breakdown of responsibilities between staff? What potential problems are being checked for and resolved? Is the accounting department following state regulations for trust accounting? A little attention to your processes in this department will pay huge dividends in preventing errors, audits, and thefts.
- **Communication Between Departments**
  When a property manager negotiates a new rate with a tenant, who finds out about it and when? Who knows information, and who needs to know it? Sketch out a standard communications loop to ensure that no one is flying in the dark and no information slips through the cracks.

As the broker/owner, it's your privilege to decide how you want your business to be run. But for it to run well, you need to put these processes in writing and communicate these to your team. Require that these tasks be done according to the process.

Two last notes here: Require of yourself that you submit to these processes. Nothing breaks down the internal structure faster than seeing that the person at the top gets to live by his own rules. Also, listen to feedback on your processes. If a new process creates new problems, adjust the process. Don't let your business become a bureaucracy.

Conduct a Thorough Monthly Review

At least once a month, review your business for both fraud and audit risk. For fraud risk, review the processes you've put in place and the internal controls you've set up. Make sure everything's working correctly. For audit risk and general business health, review the bank reconciliation reports and the individual property balances.

Summary

You as the broker/owner should take responsibility to (1) establish processes, (2) set up internal controls, and (3) conduct a thorough monthly review. Establishing the processes and controls may take some time, but once they're established you should be able to step back a bit and watch your business work.

Now that you know what to DO...

Here's What You Need to Manage

The items in this section are good candidates for delegation (note: not abdication). Oversight is still required for these, but you can assign someone else to handle the bulk of this work.

Monthly Reconciliations & Documentation

We'll discuss the reconciliation and review process in more detail in Part 3. While you as the broker/owner may not perform the reconciliation, it is important that you (or a trusted third party) review the reconciliation reports. Reconciliation satisfies state audit requirements, and your review is a key defense against significant error or fraud.

Communication Between Departments

Keep your finger on the pulse of communication. By no means do you need to initiate everything or be cc'ed on everything, but keep an ear out for the general tone of communication. Establish a culture of professional helpfulness, starting with your own example, and continue to encourage others.

Now that you know what to MANAGE...

Here's What You Need to Monitor

The items in this section are good candidates for a monthly review. They can be monitored more frequently (and some probably should be), but these are items to touch on periodically. These items serve as indicators for whether your processes and controls are working correctly. If any of these indicators seem off, follow up quickly.

Trust Account Balances

Have a general idea of how much money ought to be in the trust account. This doesn't need to be precise, just a ballpark figure. Use that figure as a quick check that the balances are reasonable.

Property Balances

If the trust accounting is being correctly handled, no property should have a negative cash balance. A negative balance indicates that this client is borrowing money from the other clients.

Security Deposit Balances vs. Liabilities

The security deposit liability on your books should equal the cash on hand in the security deposit trust account.

Summary of Broker/Owner Responsibilities

Even if you delegate everything else related to finances, take ownership of these two reviews if you're serious about keeping your business stable.

Review the Trust Reconciliation Report(s) Monthly

When reviewed thoroughly, the reconciliation reports can give you a clear idea of how money is moving in your business and whether it's moving correctly. Some companies run a daily reconciliation. This gives them the ability to immediately correct errors and to know where the finances stand at any point. Stay tuned for details in Part 3.

Review Property Balances

Make sure you don't have any negatives. This indicates that a transaction was wrongly posted or a decision wrongly made, and state auditors will immediately flag this. You may need to make corrections in the books or follow up with the client.

Also Important

- **Create internal business processes** for happier interactions and greater control over the movement of trust money through your business.
- **Create an internal system of controls**, separating responsibilities so that no one person has the unmonitored opportunity to pay themselves.
- **Review the trust reconciliation yourself**, or delegate this review to someone not connected to the accounting department.
- **Avoid delegating the check signing authority**, especially to remote employees. Reduce the chance of a fraudulent check.

Now How Am I Supposed to Do All This?

We've got you covered! Let's dive into some of the details now in Parts 3 & 4.

Conversation Roadmap

Sample Conversation Starters

Advisors

- In your words, how does trust accounting work and why should I understand it?
- What are the rules in my state that I should be aware of?
- What are internal controls and why do I need to worry about them?
- How do I write a process? Where do I start? What processes should be written first?

Team Members

- Are there times when I cause frustration because I just don't understand how something works? What are some things I should learn more about?
- How can I better support you in your role in the company?

Part 3—Reconciliation: The Cornerstone Control

Let's start with the most crucial puzzle piece of the whole package: the bank reconciliation. This one process will help you avoid most of your potential nightmare scenarios. Reconciliation satisfies a key state audit requirement and is the crucial component of your ability to catch fraud or errors quickly. Your effort in this area will yield tremendous value.

Do It

Let's start with the what, who, how and when of the bank reconciliation.

What Does It Mean to Reconcile the Bank Accounts?

- **Central idea**: The bank statement balance should match the ending balance of the reconciliation report from your software.
- A trust accounting reconciliation is a three-way reconciliation, also referred to as a "**triple tie-out**." It ties the bank balance from the statement to the bank balance in your software records, and it also checks that amount against the sum of the client and tenant security deposit ledgers (see illustration below).
- You're tracking exactly what money came in and where it came from, and what money left and where it went to.
- You'll be able to see if money should have been deposited and wasn't, or if money was spent and shouldn't have been.

Who Should Reconcile the Accounts?

Short answer: **The most experienced person on your team**. Think of your entire operation like a

Bank Statement

Statement Date:
August 31, 2021

Balance as of Statement Date:
$54,736.79

Deposits:
$122,450.44

Checks:
$48,841.01

Withdrawals:
$60,077.93

Take your bank statement's ending balance...

=

Software

$54,736.79
Adjusted Cash Balance

8/1/21	xxxx	$300.00
8/1/21	xxxx	$19.99
8/4/21	xxxx	$1.31
8/4/21	xxxx	$4422.69
8/5/21	xxxx	$310.00
8/6/21	xxxx	$25.24
8/10/21	xxxx	$17.01
8/10/21	xxxx	$300.00
8/10/21	xxxx	$300.00
8/11/21	xxxx	$19.99
8/13/21	xxxx	$6.37

...and compare it to your software's **reconciled** adjusted cash balance...

=

Client Ledgers

Client A	$1200.00
Client B	$4340.00
Client C	$7070.00
Client D	$1050.00
Client E	$2250.99
Total	**$54.736.79**

...and match that figure to the total of your client ledgers (and tenant security deposit ledgers if applicable).

large, complex golf tournament. Is there someone on your team you would trust to keep score for the whole tournament? He or she would probably be a good choice to handle the reconciliation.

How Do You Reconcile the Accounts?

- The process is specific to your software. Please reference the help content provided by each software company for specifics of how to perform a reconciliation. Following are some of the major property management software vendors.
    - Appfolio
    - PropertyWare
    - Buildium
    - RentManager
- If you run the reconciliation process and the balances don't match:
    - Compare the transactions on your statement with the transactions in your software.
        - Make sure all transactions have been entered in your software and that they've been entered correctly (correct date, amount, account).
        - Make sure that only transactions found on the bank statement are marked as reconciled in your software.
    - If the balances still don't match, you may have an opening balance error. See the "Troubleshoot It" section below.

When Should You Reconcile the Accounts?

- At a minimum, monthly. Most states require the accounts to be reconciled every month.
- Nothing prevents you from more frequent reconciliation, though, and it can be a good idea to run this check more often to make sure everything is working correctly.

Review It

For maximum impact, you—the broker/owner—should focus on this review. Even if the account balances with the statement, this review can uncover other potential issues. If you choose to outsource this review, use the following section as a guide to ask follow-up questions to your accountant. Remember, you are ultimately responsible for any problems and their consequences.

Who Should Review the Reconciliation Report?

- Someone who does not handle the routine bookkeeping. This makes it more likely that fraudulent transactions or significant errors will be uncovered quickly. **Your internal accounting team should not perform the final review.**
- You can perform the review, or you can outsource the review to a third-party accountant (or another independent and competent entity).
- Even if you outsource the review, **always review and sign off on the reconciliation reports.** As the broker/owner, you are responsible for the results of the report.

What Do You Look for When You Review the Reconciliation Report?

Uncleared items and negative property balances. Once you make the reconciliation a routine practice, it will usually be simple.

- **Uncleared Items**
  These are transactions that are recorded in your software but never hit the bank.
    - **Uncleared Deposits**
      No deposit should take more than 2-3

business days to clear. If it hasn't cleared, it likely wasn't made. Ask questions about these.

- **Uncleared ACH Payments**
  No ACH payment should take more than 1 business day to clear. If it hasn't cleared, it likely wasn't made. Ask questions about these.
- **Uncleared Checks Older than 90 Days**:
  - If a check to the management company has not yet cleared, track it down and reissue or deposit the check quickly.
  - If a check to a client or former tenant has not yet cleared, contact the client or former tenant to confirm they received the check. Reissue the check if necessary.

Sample Reconciliation Report

XYZ Trust Account

Statement Date: 8/31/2021

Beginning Balance:	$41,205.29
Cleared Deposits:	$122,450.44
Cleared Checks:	-$108.918.94
Ending Cleared Balance:	**$54.736.79**

Unreconciled Deposits
7/31/21 ACH $5,622.88
8/30/21 Deposit $2,557.13
8/31/21 ACH $10,421.65

This deposit was recorded a month ago but has not hit the bank yet. You'll want to find out why.

Unreconciled Checks
8/15/21 Check #2021 -$450.00
8/17/21 Check #2024 -$722.12
8/28/21 Check #2032 -$118.00

The rest of these unreconciled transactions are pretty recent and are likely to reconcile in the next month No need to follow up on these yet.

- **Uncleared JE's or Adjustments**
  If a JE or adjustment has not cleared, this could indicate one of several things. A transaction may have been recorded but never actually made. Or it could be a red flag for an unauthorized transaction. Ask questions about these.

- **Negative Property Balances**
  These indicate that you may be operating with a trust fund deficiency. Auditors will love to cite you or shut you down for this.
  - Check the client and tenant security deposit ledgers for negative balances. Correct any negatives quickly.
  - If a balance has gone negative and cannot be immediately corrected, keep as much documentation for it as possible, in case of an audit.
- **Anything Else that Looks Interesting or Unusual**
  Err on the side of asking too many follow-up questions, and listen closely to the answers. You may learn a piece of the process you never knew before—or you may hear something you need to explore. If you are uncomfortable with something, and the answers you hear aren't helping, you may want to consult an expert—sooner rather than later.

Document It

State regulations usually require that reconciliation reports and all supporting files or paperwork be kept on hand in case of an audit. Make this part of your normal process and you won't be caught off guard.

How Do You Prove You Reconciled the Accounts?

- Assemble and file the reconciliation-related documents.

- Print the reconciliation report that shows the triple tie-out.
- Print the client ledgers (and tenant security deposit ledgers, if any) used in the reconciliation.
- Assemble any other related documentation that helps to explain strange-looking parts of the report.
- File these with the bank statements in a folder (physical or electronic) labeled with the date and the word “reconciliation”, or whatever convention will help you to quickly locate the documents.

- Sign the reconciliation report. It is highly recommended, and even required in some states, for the broker/owner to sign the report.
- Review your state requirements:
  - Are there other reports you’re required to maintain (such as a trust account ledger)? Print these reports and file with the reconciliation documentation.
  - Is there a particular form you’re required to use? Be sure to fill it out and file it with the reconciliation documentation.

Troubleshoot It

What if, after a thorough and careful reconciliation process, all transactions are accounted for but the balances just don’t match?

One common issue happens when you change recordkeeping systems. It’s difficult to migrate all your information correctly from one system (paper or software) to another. If your team handles the migration without sufficient training or attention to detail, the new software may reflect incorrect beginning balances for various client or bank accounts—which will throw off every reconciliation in the future. This can cause problems for years before the issue is identified.

- Before importing your data to a new system, take the time to really learn how the software works, or consult a qualified expert before import.
- If you discover this problem after (maybe years after) the change to the new system, contact someone with expertise in your software who can advise you.

Become thoroughly familiar with the reconciliation process, and you will be one step ahead of most accountants in the world. Trust account reconciliation is a specialized process, but this is THE process you need to read the pulse of your business’s finances.

Conversation Roadmap

Sample Conversation Starters

Advisors

- Can you explain what I should look for when I review a reconciliation report?
- How often would you recommend we run this reconciliation?
- In my situation, who would you recommend I put in charge of the reconciliation?
- Do you know an expert in my software that I could consult?

Team Members

- Anyone like playing golf? Anyone like keeping score?
- Do we have a current reconciliation process? What does it look like? Have you encountered any strange or ongoing issues? How have we handled these issues in the past?

Part 4—Recommended Controls and Procedures

In this section we help you break down the steps in the "What you need to DO" section above—prevent fraud (by establishing controls), prevent chaos and audit panic (by establishing procedures), and periodically review the system.

Financial Controls: Reduce Opportunity for Fraud

Ever heard of the fraud triangle? It's a common way of thinking about what causes someone to commit fraud. The theory is, in every situation where fraud occurs, three elements are always present.

The fraudster has 1) pressure or motivation to take the money, 2) rationalization as to why it's not such a big deal, and 3) opportunity or access to the money.

Since the only one of the three elements that you can control is the third one[1]—the access that someone may have to steal money—that's where we'll focus in this section. We'll address three ways to reduce the opportunity for fraud, starting with the most effective method.

Segregation of Duties

As we mentioned in the last section, segregating duties means planning your workflow so that no one employee will have unmonitored access in matters involving receiving or paying money.

For example, a common practice is to hire an off-shore virtual assistant (VA) to handle some of the routine bookkeeping. If you give your VA access to your online banking or ACH payment portal so he can process vendor payments, you have handed him the keys to the kingdom. He can issue himself payments and create fake invoices in the system to hide his theft. Worse yet, because he's likely thousands of miles away, he can issue himself one big payment and then disappear, leaving you in a nightmare.

No, we're not saying your employees are scheming against you (though that can happen). But many business are impacted by fraud because the business owners thought they really knew and trusted the person who turned out to be the thief. Denial will open you up to devastating fraud. However, don't become paranoid—this will shut down your business just as surely. The best approach is to see the risks, stay alert, and employ safeguards.

In our VA example above, a better solution for handling vendor payments would be for the VA to assemble a list of the payments due and forward it to an on-site employee who can view but not edit the accounting records, and who will actually issue the payments. This way you have two sets of eyes on all payments, and neither person has unfettered access to the process.

Do you see how this works?

Think of your payroll, your process for receiving payments from tenants, your process for paying clients or vendors. Each of these processes can be vulnerable to theft if you don't have safeguards built into your process.

Below we've borrowed some ideas for segregating duties from Tiffany Couch's excellent

1 Couch, Tiffany. The Thief in Your Company: Protect Your Organization from the Financial and Emotional Impacts of Insider Fraud. Austin: Lioncrest Publishing, 2017. 147.

book *The Thief in Your Company*.[2] If this topic resonates with you, you may find it worthwhile to check out her book for a more in-depth discussion.

Don't Give One Person the Unmonitored Opportunity to:

- **Enter and pay a fake employee**
  Separate your payroll processing from human resources.
- **Write and cash fraudulent payroll checks**
  Direct deposit is a step in the right direction. Separate your payroll processing from check distribution.
- **Enter and pay a fake vendor**
  Separate your vendor management from vendor payment.
- **Enter and pay a fake invoice**
  Separate your invoice entry from invoice payment.
- **Issue themselves a fraudulent payment**
  Use two sets of eyes on all payments. For example, have one person prepare the payment and another review and send the payment.
- **Send an inflated bill to a client and pocket the extra money.**
  Separate your customer billing from customer collection.
- **Steal a portion of a customer payment and write off that portion of the customer account in the system.**
  Separate your customer collection from customer credits.
- **Steal from the prepared deposit en route to the bank.**
  Separate your receivable function from the bank deposit responsibility.

If You Don't Have Enough Employees to Divide Things Up:

- Set up regular management oversight of these transactions (see the next section).
- Consider outsourcing your payroll to ensure that checks are properly distributed and taxes properly paid and filed.
- Work with a third-party accountant to check that no odd patterns appear in the client or vendor records or bank reconciliations.

Business Owner/Manager Oversight

Whether your business is large or small, your presence and oversight will go a long way toward reducing fraud risk. Manager oversight is even more crucial for the smaller business which may not have enough manpower to thoroughly segregate duties as described above. Especially if you're not able to segregate a process, make sure you're regularly reviewing the process and its results. Ask questions if anything seems strange.

Here Are a Few Items Where Your Oversight Will Pay Off:

- **Have solid control over check writing.**
  Reserve to yourself the authority to write or sign checks.
- **Conduct a monthly review of the bank statements and canceled check images**.[3]
  This is a critical and simple defense against check disbursement fraud. Look at each canceled check image and confirm that the payee and the amount are valid.
  - **NOTE: Employees involved in accounting and processing checks and payments should not conduct this review.** If you wish to delegate the review, assign it to a non-accounting employee,

2 Couch, "Segregate Duties and Establish Internal Controls." Chap. 12 in The Thief in Your Company, 2017.

3 Couch, The Thief in Your Company, 79.

a third-party accountant, or another independent and competent person.

- **Conduct a monthly review of the bank reconciliation report.** While your internal accountant can run the reconciliation, someone who does not handle the routine bookkeeping should review the reconciliation report.
    - **NOTE: Your internal accounting team should not handle this review.** Do it yourself, assign it to a non-accounting employee or department, or outsource it.
- **Ensure that proper procedures are followed.** Frequently review the processes involving the transfer of money, especially cash handling, and ensure that all employees are following the procedure. If a procedure is not being followed, use the situation as a training opportunity.
- **Conduct a regular review of payroll reports.** Check that you recognize all payees and that the total payroll amount is within reason. Ask your payroll team if you see anything that gives you a question.

Proper Office Training

Most employees are on your side and will be glad to know what to look for. For the rogue employee, just knowing that you have well-thought-out processes to track and review the movement of money will be a deterrent to fraud.

Train Your Employees to:

- Spot red flags and initiate the proper response.
- Use direct deposit/online payments whenever possible to reduce fraud.
- Keep track of tangible received money.
- Make physical deposits regularly.
- Use the software properly.

Specific processes are discussed in the next section.

Financial Procedures: Reduce Opportunity for Error, Fraud, and Audit Issues

If an auditor dropped in to your office next week unannounced, would you be ready for him? This section is designed to help you structure your daily workflow so that you don't need to panic if this happens. We'll cover some specific audit helps before moving into some more general processes. The goal here is that you can relax mentally, knowing that your business is on track.

Audit Prep

Auditors from Any State Will Generally Want to Review the Same Types of Documents:

- Disbursement journal (checkbook register)
- Records & receipts
- Trust account balance breakdown
    - A clear view of whose money is in the account and how much. A properly maintained client ledger, and an explanation of any broker funds in the account, should satisfy this requirement.
- Bank statements
- Reconciliation reports
- Possibly access to accounting softwares

If you track every transaction in writing, enter all documentation into your software, keep bank statements on file, and run a monthly trust account reconciliation, you will have these items ready to go. Some states require that these records are readily available, so keep them in a location where you can easily reference them. Work audit prep into the normal process so you sleep at night.

Auditors will also be looking for items specific to your state.

Bank (Trust) Accounts:

- Does your state have specific wording to use for the names of your trust accounts?
- Does your state require separate trust accounts for security deposits?
- Does your state have instructions on how to handle bank fees on trust accounts?
- Does your state permit the trust accounts to bear interest?
- Does your state require you to pay interest on security deposits?
- Does your state permit any broker money in the trust accounts? If so, how much?
- What time frame does your state require for depositing trust funds?

Client Ledgers:

- Does your state permit you to move money between properties owned by the same client?

Documentation:

- How detailed does your state require your records to be?
- How long does your state want you to store your records?
- Does your state require you to use a specific form for reconciliation?

Proof of Involvement:

- Does your state require written policies and procedures?
- Does your state require your signature on reconciliation reports and other documents?

Routine Processes

No need to rush here. These may feel a bit detailed, but take some time to think through how these processes would apply to your business and how much more secure you would be against a surprise audit if these processes were routine.

Office Procedures

These are processes for your administrative employees, not necessarily accounting or bookkeeping employees. Administrative employees play a crucial role in keeping the business orderly and documented.

Cash Handling Items

Cash payments (in currency rather than by check or electronic payment) are untrackable by nature and can create huge headaches. You have no way to know how to handle a large cash deposit with no accompanying note—where it came from or where it applies. To simplify your records and your life, especially in case of an audit, consider changing your policy to not accept cash and to require a cashier's check for someone without access to a bank account. If you must accept cash, create detailed rules for how to accept it, where to place it, how to record it, and when to deposit it.

- **Track physical payments**
- Have a designated location for physical payments (cash, checks, money orders) and immediately record the payment using sequentially prenumbered receipts. This will give you a trail to follow if some of the money goes missing.
  - Check payments: Double-check that the written and numerical figures match. The bank will honor the written figure. Follow up with the payee for a corrected check if necessary.
- **Document the deposit**
- Make a copy of the physical deposit before taking it to the bank, and upload the deposit scanner image to the software. Once the deposit is complete, get the deposit slip and match it to the deposit recorded in the software. This will help to prevent double-entering receipts and to catch the disappearance of money en route to the bank. Treat it as a red flag (requiring

immediate attention) if the deposit slip doesn't match the recorded deposit.

- **Schedule regular deposits**
- Have a regular schedule for depositing physical payments, perhaps once or twice a week. Set specific times (e.g. Tuesdays at 3:00pm and Fridays at 10:00am) and prioritize this task. This will both help you comply with state regulations on depositing trust money and help you track whether all your money is making it to the bank.
- **Stay alert for changes**
- Let's say a tenant writes a check with two different amounts. The number reads "$2700" but the written line reads "Two thousand". You deposit the check at $2700, but the bank will eventually adjust your account down to $2000 to match the written line. If you've already paid your client from the $2700, you'll need to get that money back. Set up notifications with your bank so that you are notified of any adjustments to the accounts, and make corrections as soon as you are aware that they are necessary.
- **Avoid dealing in cash**
- Using an online portal for owner contributions and tenant payments will drastically reduce your time, hassle, and fraud risk in tracking payments.

Document Storage

In general, track every transaction and important communication in writing and file all documentation. Check your state's requirements for how long to maintain these records.

Require documents for daily transactions:

- Rents (numbered invoices)
- Deposits (deposit stub, sales receipts)
- Checks (checkbook register and supporting vendor invoices)
- Purchases (original or scanned receipts—no credit card statements)
- Work orders
- Other transactions
- If your software allows, upload a copy of the document and attach it to its related transaction in your software. Set up scan-and-file processes if you handle a lot of paper documentation.

Require documents for monthly reports:

- Bank statements
- Reconciliation reports and supporting documents
- Client & tenant ledger breakdown
- Keep these on file, physically or electronically—or both, if you can.

If you make a company-wide habit of backing everything up with documentation, and you set up efficient physical or electronic filing systems to handle the documentation, you'll be in a good position to meet the auditor at the door.

Tenant Move-Outs

Complete move-out procedures in a timely manner:

- Write down the various steps involved in a typical move-out. From the accounting side, include any evaluation or payment of maintenance charges against the security deposit. Ensure that all legal, logistical, and financial steps are taken in the correct order and without spending more time than necessary.

Clients & Vendors Onboarding

As mentioned earlier, an onboarding process has a two-pronged purpose: to gather all the information you need to set up your system, and to make a strong first impression. Let your company's personality shine in a well-crafted onboarding process.

Here are some ideas for setting up onboarding processes:

- **Clients**
  - Include a provision of their consent to electronic 1099 reporting in the management contract. This streamlines your process come January.
- **Vendors**
  - Collect W-9 forms during onboarding so you don't have to chase them down come January.
  - Set expectations of engagement. For example, if they want a check mailed by Friday the invoice needs to be submitted by Wednesday. Use whatever expectations make sense in your context, but be sure to define them at the start of the relationship.

Ongoing Client Relationships

Property managers are often client-focused, which is a good focus to have if you want a satisfied clientele. The downside is that it's easy to go too far to avoid irritating a client. In these instances, you may need to graciously stand your ground:

- Enforce the management contract.
- Have your client invoices in order.
- Don't pay vendors on the side without a formal invoice. Openly acknowledge all charges.
- The client should be the **last** to be paid. Deduct your management fees, pay other related charges, and then send the client the remainder. Establish this expectation up front to avoid angry conversations later.

Closing Inactive Properties

When a property is no longer under management, take the necessary steps to close the property and bring its balance to zero. An inactive property with a negative balance can be one sign of fraud.

Financial/Accounting Procedures

As you structure your processes for your internal accounting or bookkeeping team, define the process to anticipate problems and potential errors. Here are some recommendations for keeping your books in order.

Trust Accounting

- **Keep detailed and timely records of transactions**
- This should fall under the routine administrative processes above, but the state requirements are generally more stringent when it comes to the trust accounts. Both administrative and accounting employees should check for documentation.
- **Know and abide by statutory limits on broker money in the account**
- If you do (and you should) keep detailed and timely records of all money moving into and out of the trust accounts, you should have a record of how much money is due to the broker. Transfer out any money over the statutory limit.
  - Any funds payable to the broker must be transferred out within a set period of time, usually 20 days to a month. Check with your state for the time frame.
  - Many states allow a small balance of broker funds to cover bank charges. Check with your state to determine its allowed limit.
- **Maintain cash to offset the trust liability**
  In general, if the bank balance for a property is less than the liabilities booked against that property, you have a trust fund deficiency.

Treat any trust fund deficiency as a red flag alert and follow up promptly.

- **Apply payments to the correct category**
  Apply security deposit payments to the security deposit liability account. Apply fee payments to the income account.
- **Avoid the use of manual journal entries to force reconciliations.**
- **Tip: Consider keeping a maintenance reserve** for each property to avoid dipping the property trust balance below $0.

Security Deposit Accounting

- Be aware that some softwares have assumptions of how you handle security deposit transactions.
  - For example, Appfolio assumes that you will transfer funds from a security deposit account to your operating account and pay them out from there. If this doesn't reflect your actual process, you'll want to keep an eye on Appfolio-generated transactions surrounding security deposits to make sure the records are correct.
- Security deposits, and all charges against the security deposits, should be posted to the tenant ledger.
- Before paying out the deposit:
  - Confirm whether the deposit was broker-held or client-held. You don't want to spend the same money three times.
  - Review any applicable charges or interest accumulated on the deposit.
- Review your state's requirements: Some states require the payment of interest on security deposits.

Section 8 Billing

If you accept housing subsidies from government housing agencies, you may have noticed that they can be inconsistent. Remember that any overpayment is a liability, not income.

- Keep a sharp eye on any notice of a change in billing and update your bills to reflect the announced rate.
- If the Section 8 checks fail to reflect the announced rate, track any overpayments in a separate liability account and don't pay that portion out to your clients. The agency will eventually want those funds back.

Refund Handling

- **Treat all refunds as separate transactions**
  If you owe a client a refund, don't take it out of their management fees. Receive and record the full fee, and issue the refund separately. This way, you can see at a glance that you did receive all the expected income on this property, and you (and auditors) can easily tell the whole story.
- **Complete the refund process**
  When refunding a client, remember that the management company is issuing the refund. If you issue the payment from the trust account, transfer money from your operating account back to the trust account to complete the process. Otherwise you may have a trust fund deficiency that comes back to haunt you.

Reconciliation Compliance

- Reconcile the trust accounts to the bank and to the client ledgers (the triple tie-out—see Part 3 for details).
- It is also a good idea to reconcile your corporate accounting software to your property management software.
  - Do the management fees match? If not, why not?

Other

- Never set a property or client as inactive if there is a non-zero balance, whether negative or positive. This can cause reconciliation headaches and leave the door open for fraudulent payments.

  - Zero out an uncollectible amount to Bad Debt Expense.

Communication Procedures

Establish channels and expectations of communication. You know best what the structure of your business is, but put some thought into where information originates and where it's needed and design a communication system to meet those needs.

Review of Controls

At least once a month, review existing controls and procedures and ensure they're being followed.
Examples:

- Review your reconciliation report for uncleared items (checks, deposits, etc.).
- Review reconciliation reports and other related reports. Sign, date, and file.
- Review bank statements and canceled check images for anything that appears out of place.
- Confirm that broker money in trust accounts does not exceed the statutory limit.
- Review your property balances. There should be no negative or inappropriate balances.
- Review your security deposit liability on the books and confirm that your security deposit bank balance matches the security deposit liability. If it doesn't, know how to explain the difference.
- Review your management fee percentage on a property basis to ensure that all fees are being charged.
- Make sure your fee structure is correct and active in the system to ensure that the correct fees are being charged.
- At least once a year, review your state's laws governing property management and trust accounting.

Conversation Roadmap

Sample Conversation Starters

Advisors

- Where is my greatest fraud risk?
- Given my business structure, what would be the most effective ways to segregate duties and introduce appropriate financial controls?
- What are my state's laws governing property management and trust accounting? Am I fully compliant?
- In what ways am I currently risking audit exposure?
- Am I properly maintaining and storing all required documentation?
- What are my weakest financial procedures, and how can I improve them?
- Where can I focus my efforts in training?

Team Members

- Understand that we're not setting up controls because I don't trust you, but because managing other people's money is serious business. And when you live on the edge of the cliff, you need to put up safety rails.
- Do you have ideas for how to structure our processes so your workflow is smooth?
- What regular points of communication would be helpful to ensure that all processes are running smoothly?

Conclusion

Congratulations! You have just taken a major step toward increasing your satisfaction and security in your property management business. Think of this guide as a spotlight on slippery areas where many owners/brokers, even savvy ones like you, have fallen before.

The more you familiarize yourself with these ideas, the more you will see opportunities to implement safeguards into your workflow. If you can sit back and smile, knowing that your business is operating smoothly and accurately—with every dollar of earned revenue coming in, potential frauds thwarted, potential audits prepared for, and happy clients referring you to new clients—this guide will have accomplished its mission.

Glossary

Audit—An investigation to ensure compliance with all applicable laws, regulations, or conventions. In property management, the state department of real estate (or similar department) audits property management businesses and specifically their trust accounting practices

Bank balance—The amount of money in the bank at any given point in time

Bank reconciliation—A process to ensure you have record of every transaction that has hit the bank. Compare the bank balance on the bank statement with the bank balance your records show on the same date.

Books—The financial records, whether on paper or in a software

Broker funds—Money belonging to the broker/owner rather than to a client

Broker/Owner—The owner and operator of a property management business

Client—One who owns a property managed by the broker/owner

Controls—See "Internal controls"

Exposure—A term describing the level of risk you face in a particular scenario

Fraud—In this guide, refers to theft by an employee or other internal agent

Internal controls—Processes designed to reduce the risk of theft or noncompliance

Ledger—A record or list of all transactions for a specific account, property, or client

Liability—A debt or other amount you are responsible to pay in the future

Operating account—The primary bank account used for internal business transactions

Post—To enter a transaction into the books/records

Process—A detailed description of how to execute a specific task

Record(s)—Documentation of transactions or other events

Reports—Financial summaries of various points of the business. Usually can be run and printed from the software

Tenant—One who occupies and pays rent on a property managed by the broker/owner and owned by the client

Three-way tie-out / Triple tie-out—The process of bank reconciliation for trust accounts, comparing 1) the trust account balance that the bank shows, 2) the trust account balance that your records show, and 3) the sum of your client ledgers

Transaction—Any event that involves the movement of money

Trust account—A bank account holding money that belongs to other people; subject to state regulation

Trust fund deficiency / Trust account deficiency—The situation when the amount in the trust account does not match the sum of the client ledgers, or when one or more client ledgers have a negative balance

Vendor—One who supplies the business with goods or services in exchange for payment