

The Audit Process :

Your Guide to Real Estate Commission Audits
& Trust Accounting Rules



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Why We Conduct Audits:

The Division of Real Estate (DRE) conducts brokerage audits for different reasons including, but not limited to:

1. Consumer Protection
2. Ensuring broker compliance with the license law
3. Helping to educate brokers on the license law
4. We are authorized by law

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How Audits Are Selected:

Audits are selected in three different ways:

1. Random/Routine – Brokers are randomly selected
2. Stipulated – Brokers have been previously disciplined by the Commission and are required to have a follow-up audit(s)
3. Complaint based – Audits may be opened based on complaints the DRE receives as well as expanding the scope of an active investigation



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Types of Audits We Conduct:

The types of audits we are currently conducting are:

1. Property Management (PM) & Practice Audits – These audits are opened on employing brokers (ERs) & include, but are not limited to, reviewing PM files, sales transaction files, trust accts. & recons., broker forms & disclosures, E&O insurance, & office policies

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Types of Audits We Conduct Cont.:

2. Sales Only Audits – These audits are opened on brokers that engage in sales but not PM and include, but are not limited to, reviewing sales transaction files, brokers forms & disclosures, E&O, & brokerage office & relationship policies



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Types of Audits We Conduct Cont.:

3. Non-Real Estate Brokerage Services Audits– Due to the changes in Rule 5.11, we are now conducting audits on associate brokers that manage their own investment properties, including short term rentals. This primarily includes, reviewing the broker's trust & escrow account(s), 2-way reconciliations, lease, conflict of interest disclosures, and brokerage relationships disclosures.

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Types of Audits We Conduct Cont.:

Success Tip: If you are selected for an audit, DON'T PANIC! Carefully read the questionnaire that is sent to you and provide complete and accurate information. If you are confused or don't understand something, do not hesitate to ask your auditor for clarification. Also, please speak with your auditor if you need an extension to provide the requested information.



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What to Expect in 3 Steps-Step 1:

Step 1 – You will receive a Notification of Audit Letter that asks you to respond within 15 calendar days. With the Notification Letter, you will also receive the following documents & forms to complete and return...



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What to Expect in 3 Steps-Step 1

Cont.:

- Affirmation & Questionnaire (A&Q) – This form asks you to answer questions about your real estate (RE) activities over the past 12 months including how many sales transactions were completed; if you perform PM; how many properties & clients you manage; where your trust accounts are held; etc.



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What to Expect in 3 Steps-Step 1 Cont.:

- A&Q – We ask you to send your last 3 closed sales transactions files for review as well the 3-way reconciliations for all trust & escrow accounts for the last month and 3 PM files with both the tenant and owner docs.



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What to Expect in 3 Steps-Step 1 Cont.:

- Notice of Trust or Escrow – You provide this form to your financial institution where your trust accounts are held, for them to sign and attest that your accounts holding money belonging to others are actual fiduciary accounts
- Audit Checklists – This is a Division form that asks you to answer questions about your Office Policy Manual, Management Agreement, and Lease

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What to Expect in 3 Steps-Step 1 Cont.:

- Reconciliation Worksheet – This is a Division form that we ask you to complete as a cover page for your 3-way reconciliations
- Signature Card Example – This is a Division document that can be used as guidance to help you determine if your trust and escrow accounts are set up correctly as fiduciary accounts and not just business accounts

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The Audit Process-What to Expect- Cont.:

- Transaction File Checklist – This is a Division document that can be used as guidance to help determine if you have complete transaction files

In summary, you will receive the Notification Letter along with these six different forms/documents that we ask you to complete and return within 15 calendar days



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The Audit Process-What to Expect- Cont.:

Step 2 – After receiving and reviewing your responses to the Notification Letter, including the completed A&Q, Audit Checklists, 3-way reconciliations and trust account documentation, 3 sales transaction files, etc., we will review the documentation and send a Correction Letter requesting additional information and documents and/or corrections to possible license law violations

- ***The Correction Letter asks that you provide your responses within 10 calendar days***



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The Audit Process-What to Expect- Cont.:

Step 3 – After receiving and reviewing your responses to the Correction Letter, your audit will either:

- be closed with no further action and you will receive an Audit Closure Letter, or
- a report will be drafted for the Commission to review regarding possible license law violations



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The Audit Process-What to Expect- Cont.:

Any requests for extensions to respond are addressed on a case-by-case basis and brokers that fail to respond during any part of the process may receive a *Final Notice to Comply*



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The Audit Process-3-Way Reconciliations:

A big focus of the audit process, and unnecessary contributor to license law violations, is the 3-way reconciliation process and compliance with Commission Rule 5.14. However, the Division has a lot of guidance on this subject and the entire process consists of 3 simple components:

- 1. A reconciled bank statement***
- 2. A journal***
- 3. A ledger***



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The Audit Process-3-Way Reconciliations:

1. The reconciled bank statement - consists of basically three different trust account documents including the monthly bank statement, copies of all respective checks and deposits, and all uncleared transactions through the respective time frame

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The Audit Process-3-Way Reconciliations:

2. The journal - the 3-way reconciliation document that is a chronological list of all transactions (all credits & debits) in the respective time frame

**** Think of your checkbook register, every transaction needs to be recorded with proper details per Rule 5.14***



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Commission Rule 5.14. -

Recordkeeping:

An Employing or Independent Broker, must maintain, a record keeping system set forth in Rule 5.16. (Cash Accounting) consisting of at least the following:

A. A “journal”, or equiv. accounting system, which records in chronological order, all MBTO which is received/disbursed by the Firm

1. For funds received, must include:

- a. Date of receipt and deposit
- b. Name of the person giving the money
- c. Name of the person/property for which the money was received
- d. The purpose of the receipt
- e. The amount
- f. *A resulting cash balance for the account*

2. For funds disbursed, must include:

- a. The date of payment
- b. The check number or electronic transfer record
- c. The name of the payee
- d. A ref. to vendor documentation or other physical records
- e. The amount paid
- f. *Resulting cash balance for the account*

***** Think check book register *****



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The Audit Process-3-Way Reconciliations:

3. The ledger - the 3-way reconciliation document that is a list of all beneficiaries whose money is held in the trust account as of a specific date with a corresponding account balance

** The security deposit ledger = list of all tenant's security deposits*

** The owner/rental ledger = list of all rental/owner funds*



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Commission Rule 5.14. - Recordkeeping-Cont.:

5.14. Cont.:

B. A “ledger” or an equivalent component of an accounting system which records, in chronological order, all money which is received or disbursed by the Broker on behalf of each beneficiary of a Trust/Escrow Acct. The ledger record must show the monetary transactions affecting each individual beneficiary and must segregate such transactions from those pertaining to other beneficiaries of the Trust/Escrow Acct. The ledger record for each beneficiary must contain the same transactional information as set forth in subsection A of this Rule.

- ***No ledger may ever be allowed to have a negative cash balance.***
- ***The sum of all ledger balances must agree at all times with the corresponding journal after each transaction has been posted.***

*****Think list of owner/tenant balances*****



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Commission Rule 5.14. - Recordkeeping-Cont.:

5.14. Cont.:

C. Three-way reconciliation must be performed monthly to show that on the same date the cash balance shown in the journal, the sum of the cash balances for all ledgers, and the reconciled bank balance are the same

D. A Firm can deposit personal funds as may be required to pay any bank charges incurred with maintaining any Trust/Escrow Acct.

E. 3-way reconciliation documents may be kept electronically



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The Audit Process-3-Way Reconciliation Equation:

Recon. bank stmt. balance = journal balance = ledger balance



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The Audit Process-Common Violations-Statutes:

The following is a list of the common statute violations that are found:

- 12-10-217(1)(h) – failing to account for or remit money belonging to others or failing to keep records
- 12-10-217(1)(i) – converting/diverting/commingling money belonging to others or failing to keep money belonging to others in a trust/escrow account
- 12-10-217(1)(m) – violation of any commission rule
- 12-10-217(1)(q) – unworthiness/incompetency



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The Audit Process-Common Violations-Chapter 5 Rules:

The following is a list of the common Chapter 5 (Separate Accounts & Accounting) Rule violations that are found:

- Rule 5.2 – trust/escrow accounts (naming)
- Rule 5.9 – conversion/diversion prohibited
- Rule 5.10 – commingling prohibited
- Rule 5.11 – money belonging to others for non-real estate activity
- Rule 5.14 – trust/escrow recordkeeping requirements



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The Audit Process-Common Violations-Chapter 6 & 7 Rules:

The following is a list of the common Chapter 6 (Practice Standards) & Chapter 7 (Standard Forms) Rule violations that are found:

- Rule 6.3 – employing broker supervision
- Rule 6.5 – brokerage relationship disclosures in writing
- Rule 6.17 – duty to disclose conflict of interest and license status
- Rule 7.1.B. – standard forms/attorney-drafted forms



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The Audit Process-Examples of Common Violations:

Common examples that cause violations include:

- 12-10-217(1)(h) & Rule 5.14 – Failing to perform monthly 3-way reconciliations
- 12-10-217(1)(i) & Rule 5.9 – allowing individual owner ledger balances to go negative
- 12-10-217(1)(i) & Rule 5.10 – commingling broker money with money belonging to others or maintaining “cushion” of broker funds in the account



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The Audit Process-Examples of Common Violations-Cont.:

Common examples that cause violations include:

- Rule 5.2 – trust/escrow account does not include the word “trust” or “escrow” and/or is missing label identifying purpose of account (Ex. “Security Deposit” escrow)
- Rule 5.11 – security deposit for broker-owned rental not in a trust/escrow account
- Rule 6.5 – broker did not provide Broker Disclosure to Tenant or Brokerage Duties Addendum to PMA
- Rule 6.17 – broker failed to disclose in writing license status and any conflict of interest (typically when acting on own)



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Commission Rule 5.11. Money Belonging to Others (“MBTO”) for deposit by a Broker for Non-Real Estate Brokerage Services

MBTO which is accepted for deposit in connection with activities not involving Real Estate Brokerage Services must be deposited into Broker's or Firm's Trust/Escrow Accts. Such activities not involving Real Estate Brokerage Services include:

- Guest deposits for short term rentals
- Security Deposits for the broker's own rental properties
- Deposits from a buyer when a broker is acting as a builder
- Any other non-real estate brokerage service

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Commission Rule 5.11. Continued

If a broker accepts MBTO as set forth above, the Broker must:

- Deposit the funds in the Brokerage Firm's Trust/Escrow Acct. if required by the Brokerage Firm's Office Policy Manual, or
- Deposit the funds in the Broker's own Trust/Escrow Acct. as set forth in Rule 5.2 and also must comply with the following:
 - i. Rule 5.6. – Funds must be available immediately w/o penalty
 - ii. Rule 5.9. – Conversion/Diversion prohibited
 - iii. Rule 5.10. – Commingling prohibited
 - iv. Maintain a “journal” as set forth in Rule 5.14.A. & perform a monthly 2-way reconciliation (journal/recon. bank stmt.)
 - v. Rule 5.21. – Production of Docs. & Records



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The Audit Process-Possible Discipline:

If the audit identifies violations of the license law or Commission rules, the Real Estate Commission may discipline your license, which could include:

- Remedial education
- Monetary fines
- Public censure
- A follow-up audit(s)
- Practice restrictions
- Probation, suspension, and even revocation



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Division Resources:

- Division Website: <https://dre.colorado.gov/>
- Broker Practice Guidance: <https://dre.colorado.gov/division-programsreal-estate-brokerbroker-practice-guidance/separate-accounts-and-accounting>
 - *List of banks that have previously confirmed they offer trust/escrow accounts*
 - *Notice of Escrow*
 - *Trust Account Signature Card Example*
 - *FAQs on MBTO for Non-Real Estate Brokerage Services*
 - *3-way reconciliation worksheets*
 - *3-way reconciliation template*
- Broker Contracts/Forms: <https://dre.colorado.gov/real-estate-broker-contracts-and-forms>
- YouTube Video: https://www.youtube.com/watch?v=am1HdN6j_k4

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Any Questions??



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