

# Three Way Reconciliation and Trust Accounting Tips

## A Division of Real Estate Broker Advisory

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For those of us who grew up in the pre “internet everything” generation, and had to balance our checkbooks monthly, we likely know what a two-way reconciliation is, but the three way reconciliation seems to create confusion for some. The intent of this newsletter is to offer a refresher on the concepts surrounding the required monthly reconciliations as well as offer training on some of the key elements of license law surrounding trust accounting, and the challenges auditors and investigators often see, including issues surrounding software.

### Demonstrating A Reconciliation: Two-Way vs. Three-Way

**A Two Way Reconciliation:** At the end of each month, our bank sends a bank statement with all of the monthly transactions, along with the beginning and ending balance for that period. This is our starting point for a reconciliation. We need to have our checkbook register handy. This is our journal where we track all of our transactions for the month, along with the running total. We will also need a worksheet handy as we start our process.

First, we start with the ending balance. If the bank statement for the August 31, 2019 security deposit trust account has an ending balance of \$100,000, our starting point for our two way reconciliation is \$100,000. From the bank’s perspective, there is \$100,000 in available funds. Most of the time, however, we know this is not an accurate figure. Why? Because there are typically uncleared deposits into and uncleared withdrawals from the account, not reflected on the statement. For our example, let’s assume that we received our bank statement on September 5, 2019. As of August 31, 2019 our journal shows we have \$108,000 in our account. On the surface, it appears they don’t reconcile, which is why we need to do a reconciled bank statement, or worksheet.

### Worksheet Example:

|  |          |                         |
|--|----------|-------------------------|
| August 31, 2019 Ending Bank Balance                                |          | \$100,000               |
| Deposit made August 28, 2019 which has not yet processed           | add      | \$10,000                |
| Uncleared Check written August 5, 2019 which has not yet processed | subtract | <u>\$2,000</u>          |
| Reconciled Bank Statement  |          | <u><b>\$108,000</b></u> |

|                                |  |                         |
|--------------------------------|--|-------------------------|
|                                |  |                         |
| August 31, 2019 journal total: |  | <b><u>\$108,000</u></b> |

Now, you can see that both the journal and reconciled bank statement match and therefore in our two-way reconciliation example, we have reconciliation. Unfortunately, when brokers are performing reconciliations, this is where they often stop. When a broker is holding money belonging to others, there is a third component that must be compared to the reconciled bank statement and journal total, and this is the total of the ledgers.

Returning to our scenario, on August 31, 2019 we are managing 108 doors. We are holding \$1,000 security deposit for each tenant. If all of the tenants move out on the same day, and are entitled to their full deposit back, we would have to write checks totaling \$108,000. In other words, our liabilities are **\$108,000**.

|                           |           |           |
|---------------------------|-----------|-----------|
| Bank Statement Total:     | \$100,000 |           |
| A. Worksheet:             |           | \$108,000 |
| B. Journal:               |           | \$108,000 |
| C. Liability Ledger Total |           | \$108,000 |

A and B represent two-way reconciliation and A, B and C represent the three-way reconciliation.

Assets (cash in the trust account) always have to match the liabilities (total ledger balances) for the trust account. Liabilities in the account can also include sales tax held for short-term rentals, and money belonging to the broker within the trust account. The latter has restrictions and will be discussed in subsequent sections. Each individual or entity for whom the broker holds funds (including the broker's own funds) must have a separate ledger that feeds into the total.

Auditors for the Division have noticed a few things that merit consideration. First, per [Rule 5.14.A.](#), a journal (essentially your checkbook register) has to include the following:

- The date of receipt and deposit;
- The name of the person who is giving the money;
- The name of the person and property for which the money was received;
- The purpose of the receipt;
- The amount; and
- A resulting cash balance for the account.

For funds disbursed, the records maintained in the system must include:

- The date of payment;
- The check number or electronic transfer record;
- The name of the payee,
- A reference to vendor documentation or other physical records verifying purpose for payment;
- The amount paid; and
- A resulting cash balance for the account.

Without the resulting cash balance for the account after each entry, performing a three-way reconciliation will be difficult as the journal total is one of the three required components.

Because different programs refer to the reports by different names, it is critical that the employing/responsible broker understand the required elements of the report. For example, many software reports refer to the journal as the “General Ledger.” It has the same components as the journal and is therefore the journal. However, the “General Ledger” is NOT the liability ledger (C in the above illustration) for three-way reconciliation purposes.

- If you manage minimal properties and do not use software, you may find the Division’s [Three-Way Reconciliation Worksheets](#) helpful.
- Additionally, find the [Reconciliation Template](#) the auditors send to brokers to use as a cover sheet for the three way reconciliations.

## The Software Dilemma:

Software can be an essential tool for brokers managing a large volume of properties. However, auditors have noticed that software reports used for the reconciliations often do not comply with Colorado license law. In one particular case, the software being used by the broker had an option to run a report called “three-way reconciliation.” On the surface, this appeared to be a great tool. However, upon closer review, this “three-way reconciliation” report did not include a ledger total and therefore was not considered to be a compliant three-way reconciliation.

As a broker, you must review the total liabilities of your trust/escrow ledgers as part of your three-way reconciliation in order to determine if the total assets of the accounts reconcile and equal the total liabilities of the ledgers. Remember, it is your responsibility to ensure that your trust/escrow accounts, and monthly three-way reconciliations, comply with license law.

## Negative Liability Ledger Balances, What’s the Big Deal?

When reviewing ledger balances, the Division's auditors and investigators often identify a negative ledger balance(s). License law specifically states that no ledger may ever be allowed to have a negative cash balance. Negative ledger balances included in the reconciliation will underestimate the total liabilities. Generally speaking, this occurs because a broker will often pay a bill to a vendor on behalf of the owner when the owner does not have enough funds in their ledger account, or distribute money to the owner before a rent check from the tenant has cleared, and the check later bounces for insufficient funds. Both examples would result in the trust account being owed money and therefore result in a negative ledger balance. Remember, when the ledger is positive, the broker owes the money; if the ledger is negative, the trust account is owed money. What has happened in these scenarios is that someone else's money, also held in the trust account, has covered that bounced check, which in most cases is a clear indicator of diversion/conversion which is prohibited under Rule 5.9.

### Can A Broker Have a Cushion (Extra funds in the trust account) "Just In Case?"

The simple answer is no. Outside of the minimum amount of funds required to keep the account open or to cover monthly account maintenance fees, a broker cannot keep money, or a "cushion" in the trust account. If the broker does hold any money in the account to cover monthly maintenance fees, the broker must maintain a separate ledger to account for these funds.

What if there is an emergency and a check has to be written on behalf of an owner that does not have enough funds? [Rule 5.10.B.](#) discusses a provision in this particular case. A broker can advance an owner funds, but it must be properly recorded and reported. Specifically, *"Any amount advanced to a Trust or Escrow Account must be identified and recorded in the journal and the ledger and disclosed in accounting to the beneficiary as set forth in Rule 5.15."* In other words, the broker cannot just put money in the trust account to cover the check without properly identifying the purpose and recording it on the owner's ledger, and subsequent owner's statement.

### Cash or Accrual Accounting: Does it Matter?

Yes, it does. [Rule 5.16.](#) states the following: *"In the absence of a written agreement to the contrary, the "cash basis" of accounting must be used for maintaining all required Trust or Escrow Accounts and corresponding records."* However, [Rule 5.16.](#) goes on to state, *"A Brokerage Firm may use another method of accounting if it is agreed upon in writing by the Brokerage Firm and the beneficiary. The Brokerage Firm must maintain separate Trust and Escrow Accounts and corresponding records for each beneficiary using a different accounting method."*

An increasing number of brokers are hiring outside accountants to handle the trust accounts. Often times the accountants are not familiar with license law and assume an accrual basis is acceptable. In the cash method of accounting, revenue is not recognized until cash is actually paid or received. However, in

the accrual method of accounting, revenue and expenses are recorded in the period when they are earned, not necessarily when cash is paid or received. For example, under the accrual method of accounting, rental income would be recognized and recorded when it is due, not when cash is actually received. This scenario may result in situations where bills or owner distributions are made from an owner account with insufficient funds to cover the payment. As such, brokers should be aware of the increased possibility of diversion/conversion of trust account funds when the accrual method of accounting is used.

In summary, any Broker or Brokerage Firm accepting and receiving Money Belonging to Others must ensure compliance with the applicable statutes and rules pertaining to proper accounting and monthly reconciliation of Trust or Escrow Accounts. Remember to review the trust accounting rules, [Chapter 5: Separate Accounts and Accounting](#) as well the [Commission Position Statements](#) and other Chapters on the topic.

If you have questions, resources are available online or you can consult your legal counsel or compliance officer.