

## **Ten Most Common Violations Found In DRE Audits**

The real estate industry has moved into the electronic age. Accounting software systems are more sophisticated and electronic transactions are commonplace. Yet, certain things are little changed – the most common found violations in DRE Audits. The purpose of this article is to call your attention to these common deficiencies and to provide you with procedures that you can follow to ensure compliance with these laws and regulations.

### **B & P Code Section 10140.6/Regulation 2773 – Disclosure of Licensed Status, License I.D.**

Business and Professions Code Section 10140.6 states that a real estate broker shall not publish, circulate, distribute, or cause to be published, circulated, or distributed in any newspaper or periodical, or by mail, any matter pertaining to any activity for which a license is required that does not contain a designation disclosing that he or she is performing acts for which a license is required. This section requires that a real estate license shall disclose his or her license identification number and, if a mortgage loan originator, the unique identification number assigned to the licensee by the Nationwide Mortgage Licensing System and Registry, on all solicitation materials intended to be the first point of contact with consumers and on real property purchase agreements when acting as an agent in those transactions. Regulation 2773 provides a list of some materials which qualify as first point of contact materials.

Violations cited on audit cases related to this code section and regulation usually relate to the failure to display license numbers on business cards, purchase agreements and websites.

### **B & P Code Section 10159.5/Regulation 2731 – Use of False or Fictitious Name**

Business and Professions Code Section 10159.5 and Commissioner's Regulation 2731 together state that a licensee shall not use a fictitious name in the conduct of any activity for which a license is required under the Real Estate Law unless the licensee is the holder of a license bearing the fictitious name. Brokers should periodically check their license status with the Department to be sure that their license bears the fictitious name(s) they are using. Many brokers cited for violation in audits believed that having the dba registered with the county was sufficient to allow them to use it in their real estate business. Other brokers who are cited for this violation state that they had the fictitious name on their license at one time but may have had their license lapse for a brief period of time and failed to add the dba back on to their license.

### **Regulation 2831 – Trust Fund Records To Be Maintained**

This regulation requires the broker to maintain, in columnar form, a record of all trust funds received and deposited by the broker. At a minimum, the following information must be indicated in columnar form in chronological order: date funds were received; name of payee or payor; amount received; date of deposit; amount paid out; check number and date; and the daily running balance of the trust account. If any of these columns are not present, then there is a violation of Regulation 2831. The accurate use of DRE form RE 4522 fully complies with this regulation. A broker should also maintain a separate RE 4522 for each trust account.

When we cite this regulation, most of the time it is for one or more of the following reasons:

## California Department of Real Estate

- The broker did not maintain any trust fund records.
- If trust fund records were maintained, they were either not in columnar form or a column (noted above) was missing. In some instances, columnar records were maintained by a licensee but he/she was still cited because the items posted were not accurate, e.g., when posting a check, it was the wrong amount, or, for a deposit, “the amount” was wrong or “the date of deposit” was the wrong date.
- A broker maintaining columnar records can still be cited if a daily running balance is not maintained or is inaccurate. Brokers must always keep a daily running balance of the aggregate amount of trust funds in their bank accounts.

(For trust funds not deposited into a trust account, the columnar record should show the date trust funds were received, the form of the trust funds, amount received, description of the property, identity of the person to whom funds were forwarded, and date of disposition. The accurate use of DRE form RE 4524 fully complies with this part of the regulation.)

It should be noted that records maintained under an automated data process system in accordance with generally accepted accounting principles should be in compliance as long as they contain the elements previously noted and are maintained in a format that will readily enable tracing and reconciliation in accordance with Regulation 2831.2.

### Regulation 2831.1 – Separate Record for Each Beneficiary or Transaction

This regulation requires the broker to maintain, in columnar form, a separate record of trust funds for each beneficiary or transaction accounting for all funds which have been deposited into a trust account. This record identifies which beneficiary has funds in the trust account. This record must indicate the following in chronological order and in columnar form: date of deposit, amount of deposit, name of payee or payor, check number, date and amount, and running balance of the separate record after each transaction on any date.

This regulation is cited mostly due to one or more of the following reasons:

- The broker did not maintain any separate records for each beneficiary.
- In some cases, a broker maintained separate records but was still cited because it was not in columnar form or a column was missing.
- Separate records were maintained, but the broker was cited because information was missing.
- Separate records were maintained, but the broker was cited because the items posted were not accurate, e.g., when posting a check, it was recorded in the wrong amount, or, for a deposit, “the amount” was wrong and/or “the date of deposit” was the wrong date.
- A broker was unable to identify ownership of funds received via electronic deposits.
- Separate records were maintained, but a daily running balance for each record was not maintained or it was not accurate. Brokers must always keep a daily balance for each separate record.

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## California Department of Real Estate

the elements previously noted and are maintained in a format that will readily enable tracing and reconciliation in accordance with Regulation 2831.2.

### Regulation 2831.2 – Trust Account Reconciliation

Regulation 2831.2 requires that the total of all Separate Beneficiary or Transaction Records maintained pursuant Regulation 2831.1 is reconciled with the balance of the Record of All Trust Funds Received and Paid Out required by Regulation 2831, at least once a month except when the bank account did not have any activities. The requirement is that the accounting records be reconciled to each other. This is not only a legal requirement. This is also part of a sound internal control for trust fund handling.

In order for this procedure to have a reliable result, the Record of All Trust Funds Received and Paid Out must be reconciled first with the bank account statements as of a certain cut-off date. This procedure is commonly known as bank reconciliation and is performed to determine the accuracy of the records. A cut-off date is the calendar date (usually end of the month), when no transaction or activity thereafter is considered. This process is completed once all adjustments and corrections of any reconciling items had been made to the ending balance on each record to arrive at an adjusted cash balance. In other words, the balance of the record of all trust funds received and paid out has to equal the adjusted cash balance.

The next step is to compare and reconcile the total of all beneficiary or transaction records with the adjusted cash balance as of the cut-off date of the bank reconciliation. The main objective of this procedure is to determine, based on the records, whether all trust funds held on behalf of others are on deposit in the corresponding trust account. Another purpose of this procedure is to ascertain that there is no unidentified overage or broker's funds in excess of \$200 in the trust account. Any discrepancy must be corrected accordingly. The broker is required to maintain a record of the trust account reconciliation showing the name of the bank account and number, date of the reconciliation, account number or name of the principals, beneficiaries or transactions and the amount of trust funds held by the broker for each of the principals, beneficiaries or transactions. Failure to comply with this Regulation could result in substantial loss of trust funds and disciplinary action against the broker by the Department.

For an informative, step-by-step demonstration of this process, please see the PowerPoint presentation on the DRE website at:

<http://www.dre.ca.gov/files/ppt/TrustAccountReconciliation.ppsx>

### Regulation 2832.1 – Trust Fund Handling for Multiple Beneficiaries (Trust Fund Shortage)

Regulation 2832.1 requires the real estate broker to obtain written consent from every owner of the trust funds in the bank account prior to each disbursement if the disbursement will reduce the balance of the funds in the bank account to an amount less than the existing trust fund liability of the broker to all owners of the funds. A trust fund shortage therefore exists when the following conditions are present:

1. The balance of the bank account is less than the total trust fund liability of the broker to all owners of the funds; and

## California Department of Real Estate

2. There is no written authorization from all owners of the trust funds, prior to each disbursement that caused the shortfall, allowing this.

The more obvious reason for a trust fund shortage is the intentional misuse (conversion) of trust funds. However, simple record keeping errors that remain undetected could result in trust fund shortages and an actual loss of funds. Failure to record a disbursement, or understating the amount of a check disbursed, or overstating the amount of a deposit on the beneficiary ledger/record will cause the beneficiary ledger to show a balance that is larger than the true amount owed to the individual beneficiary. This overstated balance on the ledger is more likely to be paid and, consequently, the beneficiary will be paid more than what is due. The end result is a trust fund shortage.

Performing the proper trust account reconciliation pursuant to Regulation 2831.2 should enable the broker to detect such causes of a trust fund shortage.

### [B & P Code Section 10145/Regulation 2832 – Trust Fund Handling](#)

Section 10145 and Commissioner's Regulation 2832 together require that a broker place funds accepted on behalf of another into the hands of the owner of the funds, into a neutral escrow depository or into a trust fund account in the name of the broker, or in a fictitious name if the broker is the holder of a license bearing such fictitious name, as trustee at a bank or other financial institution not later than three business days following receipt of the funds by the broker or by the broker's salesperson. Two of the most common problems found in audits related to this regulation are:

- 1) A broker's failure to designate accounts receiving trust funds as trust fund accounts in the name of the broker or broker's dba as trustee; and
- 2) Failure to deposit trust funds received by a broker or broker's employee into a trust fund account within three business days of receipt.

Other common violations of these sections relate to a broker's use of an improper interest-bearing account {Section 10145(d), Regulation 2832(b)}, a broker's failure to place checks received from an offeror into a neutral escrow depository or trust fund account in a timely manner following acceptance of an offer {Regulations 2832(c & d)} and failure of a broker acting as an escrow holder in a transaction in which the broker is performing acts for which a real estate license is required to place trust funds received as required not later than the next business day following receipt of the funds {Regulation 2832(e)}.

### [B & P Code Section 10145/Regulation 2834 – Trust Account Withdrawals](#)

Section 10145 and Commissioner's Regulation 2834 together require withdrawals be made from a trust fund account of an individual broker only upon the signature of that broker, or in the case of a corporate broker, only upon the signature of an officer through whom the corporation is licensed pursuant to Section 10158 or 10211, or one, or more, of the following persons if specifically authorized in writing by the individual broker or officer:

## California Department of Real Estate

- (A) A real estate salesperson licensed to the broker.
- (B) A person licensed as a broker who has entered into a written agreement pursuant to Section 2726 with the broker.
- (C) An unlicensed employee of the individual broker, if the broker has fidelity bond or insurance coverage equal to at least the maximum amount of the trust funds to which the unlicensed employee has access at any time.

The bonds or insurance providing coverage must protect the broker from intentional wrongful acts committed by an employee of that business, including theft, dishonest acts, or forgery. Bonds and insurance providing coverage may be written with a deductible of up to 5 percent of the coverage amount. For bonds and insurance with a deductible, the employing broker shall have evidence of financial responsibility that is sufficient to protect members of the public against a loss subject to the deductible amount.

The evidence of financial responsibility shall include one or more of the following:

- (i) Separate bond or insurance coverage adequate to cover the amount of the deductible.
- (ii) A cash deposit held in a separate account, apart from other funds of the broker, the broker's employees, or the broker's principals, in a bank or recognized depository in this state adequate to cover the amount of the fidelity bond deductible and held exclusively and solely for the purpose of paying the fidelity bond deductible amount.
- (iii) Any other evidence of financial responsibility approved by the commissioner.

A broker or broker-officer is responsible or liable for the handling of trust funds regardless of the existence of any authorization given regarding signature authority.

The most common violations found in audits related to Section 10145 and Regulation 2834 are:

- 1) The failure of the broker or designated officer to be a signatory on the trust account (this may indicate a supervision problem).
- 2) Presence of an unlicensed signatory on the trust account who does not have fidelity bond or insurance coverage.
- 3) Fidelity bond or insurance coverage is inadequate in amount.
- 4) The failure of the broker or designated officer to give specific written authorization permitting a salesperson, broker or unlicensed person to sign on the trust account.

[B & P Code Section B&P Code Section10145/ B&P Code Section 10176\(e\)/Regulation 2835 – Commingling](#)

## California Department of Real Estate

A broker shall not commingle with his or her own money or property the money or property of others which he or she receives and holds. Common causes of this violation are the deposit of trust funds received into the broker's general business account or maintenance of over \$200 in broker funds in a trust account holding trust funds.

A common example of this violation on mortgage loan audits is when a broker deposits credit report fees and/or appraisal fees received into his or her general bank account instead of a trust account when he or she has not yet paid the bill. Often, the reason for this violation is that the broker does not maintain a trust account or the broker was not aware that credit report fees and appraisal fees are trust funds.

### [B & P Code Section 10159.2/Commissioner's Regulation 2725 – Broker Supervision](#)

Commissioner's Regulation 2725 requires that a broker shall exercise reasonable supervision over the activities of his or her salespersons. Reasonable supervision includes, as appropriate, the establishment of policies, rules, procedures and systems to review, oversee, inspect and manage:

- (a) Transactions requiring a real estate license.
- (b) Documents which may have a material effect upon the rights or obligations of a party to the transaction.
- (c) Filing, storage and maintenance of such documents.
- (d) The handling of trust funds.
- (e) Advertising any service for which a license is required.
- (f) Familiarizing salespersons with the requirements of federal and state laws relating to the prohibition of discrimination.
- (g) Regular and consistent reports of licensed activities of salespersons.

A broker is also required to establish a system for monitoring compliance with these policies, rules, procedures and systems.

The most common audit violation related to Regulation 2725, and to B&P Code §10159.2 for corporate brokers, is when there are many trust fund handling-related violations demonstrating a lack of oversight by the broker or officer in the area of the handling of trust funds. Often, the broker or corporate officer is not a signatory on the trust account and is largely or wholly not involved in trust fund oversight. In other cases, there is a lack of written policies, rules, procedures and systems to review, oversee, inspect and manage activities in the office(s) and/or a lack of a system for monitoring compliance.

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In conclusion, as you race to keep up with the ever-changing opportunities that present themselves in business today, take a moment to stop and ensure that your business is operating in compliance with these and other critical real estate laws.

For further information, you may wish to review the Broker Compliance Evaluation Manual:  
<http://www.dre.ca.gov/files/pdf/brkrcomp.pdf>