A Preliminary Study on the use of Forensic Accounting techniques to determine property agency trust accounting compliance

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ABSTRACT

In the late 1800's the New South Wales government commenced to regulate the property industry in order to manage property agents. The regulation of property agency is now part of the Property Stock and Business Agents Act 2002, which is administered under the auspices of the Office of Fair Trading. Now, over one hundred years later, and with numerous changes aimed at improving consumer protection and providing a higher accountability standard, the Office of Fair Trading recently reported an increase in fraud relating to property agency's trust accounts.

The Property Stock and Business Agents Act 2002 Act also stipulates that all agency businesses should be *"effectively controlled and supervised by a licensed agent"*, and in particular where there are large sums of money held by way of a trust account. Additionally, the Act has also clarified the responsibilities of licensees for their employee's conduct.

Using forensic accounting technique, this paper critically examines those provisions of the Property Stock and Business Agents Act 2002, and accompanying Regulations that relate to trust accounting policies and procedures. The findings identify a number of problem areas with respect to consumer protection that call into question the adequacy of current legislation. The paper concludes with suggestions and recommendations for improving the present regime and thereby enhancing client protection and consumer confidence with property agency.

KEYWORDS: Property agency, trust accounts, forensic accounting

1. INTRODUCTION

In the late 1800's the New South Wales government commenced to regulate the property industry in order to manage property agents. The regulation of property agency is now part of the Property Stock and Business Agents Act 2002, and the associated regulations (the Act), which is administered under the auspices of the Office of Fair Trading. Now, over one hundred years later, and with numerous changes aimed at improving consumer protection and providing a higher accountability standard, the NSW Office of Fair Trading recently reported an increase in fraud relating to property agency's trust accounts.

The NSW Office of Fair Trading, in July 2008 released *The Report - Statutory review of the Property, Stock and Business Agents Act 2002,* and identified in chapter 12 of this report, the following reasons as risks associated with trust accounting:

1. Lack of knowledge in trust accounting.
2. Failure to implement proper trust accounting systems.
3. Failure to monitor trust accounting systems.
4. Failure to review trust accounting systems.
5. Failure to monitor the actions of staff.
6. Failure to comply with audit requirements.
7. Fraudulent conduct.

The table below, identified as *figure 1*, shows that during the financial years ended 30^{th} June 2003 to 30^{th} June 2007, claims paid against the statutory compensation fund for failure to account accurately by property agencies, were between $362,000 to $1,024,000.

STATUTORY COMPENSATION FUND CLAIMS

YEAR	TOTAL AMOUNT PAID	NUMBER OF CLAIMS
2003	$ 362,400	35
2004	$ 763,524	276
2005	$ 751,196	146
2006	$ 1,024,096	82
2007	$ 918,906	264

Figure 1

Source:

The Report - Statutory review of the Property, Stock and Business Agents Act 2002, Chapter 12.

This same report also estimated that approximately $1,089 billion trust moneys were held by property agencies for the financial year ended 30th June 2007. The Fair Trading Minister announced on 7th July 2008, a funding grant of $276,000 per annum to support training, research and educational programs for property agency licensees and employees. The aim of the grant being to educate people working in property agency related business and so to ultimately protect consumers involved in the property services industry. Currently there are approximately 22,000 property agents in NSW, comprising of real estate agents, business brokers, and strata management companies. Each year the Office of Fair Trading receives approximately 2,000 consumer complaints which are associated with the property services industry.

2. BACKGROUND

In NSW, every property agent is liable at common law and statute law to account to their principal for any money held, collected, or disbursed on their behalf. Examples of a principal include landlords and vendors.

2.1 WHAT IS TRUST ACCOUNT MONEY

Trust account money is the money that an agent has collected on behalf of their principal. Antoniades H 2007. Examples of trust money include deposits on sales, rent from tenants, bonds and prepaid advertising.

The Real Estate and Business Agents Supervision Board (REBA) of Western Australian, defines trust money as *"the money is received or held by an agent or any member of an agent's staff on behalf of another person in relation to a real estate or business sales transaction or property management transaction".* In conclusion, trust money is broadly classified as money held by an agent on behalf of a property owner.

2.2 TRUST ACCOUNTING

Trust Accounting is the recording, classification, reporting and analysis of all trust money received by an agency on behalf of their principal. In addition to the mathematical aspect, trust accounting is also concerned with the agency's books and records complying with the Property, Stock and Business Agents Act 2002, and the associated regulations to the act. Antoniades, 2007. There are basic trust accounting steps which must be followed in order to comply with the act.

- ***FIRST STEP*** - All transactions must be entered on to a source document. This provides written evidence of the transaction, and is also required for compliance with clauses 25 to 27 inclusive, of the regulations to the Act. Some examples of source documents in a Real Estate agency, are receipts, cheque butts, bank deposit books and invoices.

- ***SECOND STEP*** - Source documents are entered into journals. These journals are called "books of original entry". Clauses 28 and 29 specify the exact information which must be recorded in the journals.

- ***THIRD STEP*** - Post the journal entries to the ledger accounts. (Entering transactions from the journal to the ledgers is called posting). The ledgers which are detailed in clause 30 of the regulations to the Act, are called "books of secondary entry".

- ***FOURTH STEP*** - Extract a trial balance. A trial balance, Clause 31, of the regulations to the Act, is a listing of all the balances in the trust account ledger. It verifies that the debits equal the credits.

- ***FIFTH STEP*** - Prepare reports e.g. Landlords will require a monthly rental statement. Vendors will require a settlement statement.

Below in Figure 2 is the *Trust Accounting Flow chart* which is detailed and referenced in clauses 25 to 31 inclusive of the regulations to the Act.

Figure 2

FLOW CHART FOR THE TRUST ACCOUNTING CYCLE

		TRANSACTIONS		
		↓		
RECEIPTS	←	**SOURCE DOCUMENTS**	→	**CHEQUES**
		↓		
CASH RECEIPT JOURNAL	←	**JOURNALS** Books of original entry	→	**CASH PAYMENT JOURNAL**
		↓		
		LEDGER ACCOUNTS Books of secondary entry		
		↓		
		TRIAL BALANCE		
		↓		
LANDLORD STATEMENTS	←	**REPORTS**	→	**SETTLEMENT STATEMENTS, ITEMISED ACCOUNTS**

Source: *Antoniades H. Real Estate Trust Accounting 6th Edition 2007*

A discussion paper which was issued by the Office of Fair Trading in December 2004, identified that trust account deficiencies and actions of dishonesty had been disguised by licensees and their employees using various methods of application. This included but was not limited to actions such as late or short banking of trust moneys and falsifying entries in the financial records of the trust accounts. There was also the issue of incorrect premature trust fund withdrawals for sales deposits and rentals collected. In some instances there was evidence of non lodgement of funds collected for sales deposits, which should in fact have been retained in the sales trust account pending settlement and any required appropriate authorisation for the disbursement of funds. Another issue of contention was the advance payment of commission from sales deposits prior to settlement, and also advance commission for property management prior to accounting to the landlords.

Sales deposits have the added complexity of a three-fold transaction process. When the purchaser gives the property agency a deposit, the funds are held in trust on behalf of the purchaser, pending the final process of an option being exercised or an exchange being effected. At the point in time of the option being exercised or the exchange taking place, the deposit is then held by the property agency on behalf of both the vendor and the purchaser. Once settlement occurs, and assuming the appropriate *Order on the Agent* has been received, the trust funds currently held on behalf of the vendor and purchaser, will belong to the vendor only. An *Order on the Agent* is the written instructions from the purchaser or their representative e.g. solicitor, authorising the agent to account to the vendor for all moneys held in trust, on behalf of the purchaser. Antoniades H 2007. The agent is not allowed to withdraw the commission or the balance of the settlement funds from the deposit, without this authorisation.

Below in Figure 3 is a flow chart displaying the process of trust money ownership for a sales transaction.

Figure 3

THREE STAGE PROCESS OF TRUST MONEY OWNERSHIP FOR A VENDOR AND PURCHASER

DEPOSIT FROM PURCHASER → FUNDS BELONG TO PURCHASER

↓

EXERCISE OF AN OPTION OR EXCHANGE OF CONTRACTS →
FUNDS BELONG TO BOTH VENDOR AND PURCHASER

↓

SETTLEMENT

↓

VENDOR RECEIVES SETTLEMENT FUNDS

Therefore, there are three stages of ownership in a sales transaction for trust money.

2.3 COMPENSATION FUND

The purpose of the compensation fund is to reimburse landlords, tenants, vendors or purchasers who have suffered financial loss due to a licensee failing to correctly account for funds held in the trust account of the property agency. The majority of the funding for the compensation fund is through licensing revenue received by the NSW Office of Fair Trading from the issuing of property agency certificates of registration and also license renewals.

3. WHAT IS FORENSIC ACCOUNTING

Forensic accounting involves the assimilation of accounting principles, information technology and investigative skills. In essence, forensic accounting seeks to look beyond the numbers and mathematics of a property agencies trust account.

Therefore, the property agent should be familiar with legal concepts and procedures, and incorporate analytical, interpretative and methodical summaries of the trust account related documentation.

Zyzman states that forensic accounting is the integration of accounting, auditing and investigative skills. Furthermore this technique provides an "accounting analysis that is suitable to the court which will form the basis for discussion, debate and ultimately dispute resolution" Therefore forensic accounting for property agency trust accounts is a combination of both litigation support and investigative accounting which include both legal concepts and procedures.

In trust accounting, investigative accounting will include the review of factual information and if necessary liaison with other industry experts and then plan a course of action. This could also include the recovery of missing money, whether by way of civil action or criminal prosecution. Investigations might involve the requirement of fund tracing, or perhaps even the recovery of other assets which could be deemed to represent the missing trust funds. Additionally it would be typical to carry out due diligence reviews as part of the investigation process. If it was suspected that employee fraud was involved, then it might be necessary to interview personnel who had access to the trust funds, and prepare a detailed review of any documentary evidence. The investigative process is similar to the definition of an audit, which is primarily concerned with the examination of records or financial accounts to check their accuracy. The broadest definition of an *audit* is the evaluation of a person, organisation, system or process. Generally, the purpose of the audit is to express an opinion, with the trust account audits requiring the auditor to verify that the trust account books completely comply with the Act and Regulations. Usually statistical sampling is adopted for trust accounting audits with the auditor ascertaining the validity and reliability of the information.

On the other hand, litigation support is primarily concerned with the necessary documentation and evidence required to support or refute a claim. The term *best evidence* refers to all the evidence submitted to prove the claim, whereby the evidence must be the original documentation. If this is not available, there must be evidence to show why the original is not available, and proof that the copy is a true and accurate copy of the original. Silverstone & Sheetz 2007.

4. RESEARCH OBJECTIVE

With the recent revelation of the increase in fraud with agency's trust accounts, questions regarding the adequacy of the present legislative system arise. The research objective of this paper seeks to critically examine the provisions of the Act and accompanying Regulations that relate to trust accounting policies and procedures.

The paper will conclude with suggestions and recommendations where necessary, for improving the present regime. This will consequently, enhance client protection and consumer confidence with property agency.

5. RESEARCH METHODOLOGY AND LIMITATIONS

Using forensic accounting techniques, this paper critically examines the Regulations to the Act, Part 4, Trust Money, clauses 21 to 22 inclusive; and clauses 25 to 29 inclusive. Clause 24, which relates to computer systems control has not been included in the research methodology of this paper due to the fact that this clause is a specialty clause exclusively for computer software systems. It is beyond the scope of this research paper to incorporate the available software systems currently operating in property agencies and test their compliance with the Act and Regulations. Whereas the other clauses mentioned in this paragraph govern the application policies and procedures of the accounts regardless if the trust accounts are administered manually or by a computer system.

6. RESEARCH AND DISCUSSION

The purpose of the present framework of the Act, is to regulate the property agency industry in NSW. One of the primary objectives of the Act includes a requirement to minimise consumer risk.

6.1 CLAUSE 21 BANKING OF TRUST MONEY

Generally clause 21 of the Act, stipulates that a licensee is required to "bank trust money before the end of the next banking day or if that is not practicable as soon as practicable after that day". Antoniades 2007. Whilst the legislation appears to have adopted a lenient and flexible approach to the interpretation of "is not practicable", there appears to be very little requirement to substantiate this interpretation, whereas in fact funds might not be banked for many days yet to come. So, if a licensee stated that they were short staffed and there was no one to physically attend to the banking; or the licensee stated that there was a traffic jam and they did not arrive to the bank by the close of business, is the licensee breaching the legislation?

Ultimately, the purpose of this clause is to ensure that funds are banked within the appropriate time frame. For example trust money received on a Friday or Saturday would need to be banked by close of banking hours on the following Monday, and trust money received on Tuesday would need to be banked by close of banking hours on the Wednesday. Forensic accounting would seek to investigate the legitimacy of any late banking and require a detailed explanation of why the banking was delayed and supported by evidence such as the traffic delays, staff absenteeism, and also the frequency with which the banking took advantage of "is not practicable", and did not bank by the next banking day. Some might argue that if the trust funds consist of all cheques then it does not matter if the banking is delayed, because the cheque funds are not misappropriated since cheques are negotiable instruments and are not in a cash format. Does this then indicate that the legislation should be amended to state that all cash trust funds MUST be banked by the next banking day, and only cheque trust funds can be banked as soon as practicable?

From the evidence of the recent findings with the office of Fair Trading it appears to be an obvious problem that trust funds are not being banked on time; hence there is misappropriation of funds.,

6.2 CLAUSE 22 RECORDS OF TRUST MONEY TO BE KEPT BY LICENSEES

This is a general clause which covers three main points. The first and second points within this clause, being that the books and records must be kept at the licensee's registered office. This is particularly important, because Section 105 additionally states that the *licensee records are at all reasonable times open to inspection by an* *authorised officer.* Antoniades 2007. With forensic accounting the safe keeping of all records including current and archived records should be considered. It is usual to store the archived records in a secure place away from the office premises.

The third point refers to the trial balance which must be prepared within 21 days after the end of each month. In fact this third point is comprehensively covered under clause 31, and therefore it would create a duplication to mention issues under this present clause 22.

6.3 CLAUSE 25 RECEIPTS FOR TRUST MONEY

This clause is primarily concerned with the detail of information shown on a trust receipt. The receipt of trust money can include deposits from purchasers, rent money from tenants, bonds from tenants, and advertising and auction money from vendors. Under this clause, the required information on the receipt includes date of issue, receipt number, name of licensee, the words "Trust Account", name of person paying the money, clients details, particulars of the transaction, amount and whether funds were cash, cheque or electronic funds transfer, position of the rental account and the date to which the rent was paid. During the normal course of verifying the banking of money with the receipts issued, if a receipt was not issued immediately, and was delayed to coincide with the banking of the trust funds, then it would appear that the banking of "as soon as practicable" was being adequately followed. However, it seems that there is no requirement to show on the trust receipt the date that the funds were actually *received.* The receipt requirement is only to show the date of the *issue* of the receipt. Therefore, these two dates could be clearly different. Forensic accounting however, would prescribe the requirement of these two dates as a check method against fund misappropriation.

6.4 CLAUSE 26 PAYMENT OF TRUST MONEY

This clause states that trust money cannot be drawn from a licensees trust bank account unless it is by way of a cheque or electronic funds transfer. Many years ago, it was possible to cash trust account cheques, however, because there was no paper trail existing with cash cheques, the legislation was changed to disallow the cashing of trust cheques under any circumstances. With forensic accounting techniques, this recent change would be endorsed as an excellent control mechanism for creating an appropriate paper trail for the disbursement of funds from the trust account.

6.5 CLAUSE 27 TRUST DEPOSITS

One of the main requirements with trust deposits is the need to enter the particulars of the cheques onto a deposit slip, which is part of the bank deposit. Information such as cheque particulars, including the name of drawer, bank and branch and amount of each cheque, plus the denomination of cheques, coins or notes also needs to be noted on the trust deposit book. Forensic accounting techniques would endorse, this method of verification . An excellent cross reference with the Act and Regulations, is found in clause 25 which requires the receipt details to indicate if the money received was by way of cash, cheque, or electronic transfer

6.6 CLAUSE 28 RECORD OF TRUST ACCOUNT TRANSACTIONS

This clause covers in great detail the information and format for the cash book, which represents the recording of information of money in and out of the trust account. The clause states that *these entries should be entered as soon as practicable after the transactions were effected.* Antoniades 2007. Again how does one constitute or define "as soon as practicable" ?

If trust funds are collected on Monday, and the receipt is issued on Thursday, and the funds are banked on Friday, and then entered into the cash book the following week on Monday or Tuesday, there has been a lack of accountability due to this time delay. The Forensic accounting technique would require verification from the first point of entry, i.e. the issuing of the trust account receipt, was actually issued on the same day of notification that trust refunds were received. The receipt transaction can then easily be traced through the following steps as indicated earlier in this paper, namely *figure 2*, the trust accounting flow chart.

Additionally, clause 28 requires the cash book to be balanced at the end of each month. However how do we define "the end of each month"? . In particular at

Christmas, many agents close off their books prior to the 24th December; and subsequently nominate "the end of month" to coincide with the issuing and accounting of funds to the landlords. Therefore, "the end of month" could very well be anytime from the 20th December to the 24th December. Forensic accounting would argue that "the end of month" is the last business day of the month. So, in conclusion this time lag could again encourage and camouflage misappropriation of trust funds.

6.7 CLAUSE 29 JOURNAL

This clause refers to the information that is required to be recorded when transferring funds between ledger accounts within the licensees trust account. Examples include a purchaser placing a deposit on the purchase of a property, with the purchaser later changing their mind and deciding to purchase another property which is listed on the agency's books. Instead of issuing a refund cheque to the purchaser, and then taking a new deposit from the purchaser, the funds can simply be transferred from one ledger to another ledger, within the agency's trust account system. One of the requirements in the Act is to records details and reasons for the transfer of funds. Forensic accounting requires the substantiation of this transfer, however, there is no such requirement within the legislation, and the auditing process would only check the mathematical components and therefore possibly transfer funds to a false and non existing ledger account

6.8 CLAUSE 30 TRUST ACCOUNT LEDGER

This clause is concerned with the recording of information for each principal's account/ledger. Primarily the clause states that the ledger must balance after every transaction. This is very important because a ledger should never have a debit balance. However, clause 30 does not clearly state this fact, and it is only under the computer systems control clause 24 that this issue is mentioned, however, if the books are kept under a manual system, then clause 30 does not reiterate this very important point. Forensic Accounting would require a complete explanation and documentation on how the debit balance did occur and ensure measures were in place for the mistake to not occur again.

6.9 CLAUSE 31 TRUST ACOUNT LEDGER TRIAL BALANCE

This clause deals with the trial balance that must balance with the cash book. The licensee is given 21 days after the end of each month to prepare this trial balance. However, there is no further information of what constitutes "the end of each month". Some agencies close off their books anywhere from the 27th to 31st of each month. Therefore, is the trial balance prepared at the 30th/31st of each month or when the agencies close off their books and prepare their end of month procedures? Again overdrawn accounts might not be obviously highlighted with the agent being able to select when "the end of month occurs".

7. CONCLUSION and RECOMMENDATIONS

A number of problem areas have been identified within the legislation, coupled with inadequate internal controls. In particular the wide "interpretation" available within the legislation itself appears to have ultimately encouraged the misappropriation of trust funds, and this is further evidenced in figure 1, which shows an increase in fraud since 2003.

Below in figure 4 is a summary highlighting the problem areas identified within the legislation, being selected clauses ranging from numbers 21 to 31 of the Act.

SUMMARY OF PROBLEM AREAS IDENTIFIED WITHIN THE LEGISLATION

CLAUSE NUMBER	PROBLEMS IDENTIFIED THROUGH FORENSIC ACCOUNTING
21	• Interpretation of *"if that is not practicable, as soon as practicable after that day"*
25	• Receipts issued should state the date that the trust funds were received
26	• There is no requirement to keep a controlled money register, once the funds are invested to earn interest.
28	• There is varied interpretation of the "cash book must be balanced at the end of each month"
29	• No requirement to have paper trail for the transfer of funds
30	• Does not state that the ledger should not result in a debit balance • There is no requirement to keep individual ledgers for the money invested outside the main trust account.
31	• There is no requirement to list funds held in the investment trust accounts. • Interpretation of the *"within 21 days after the end of each mont*h"

Figure 4

Many organizations have introduced the concept of self-audit, as a process of controlling and minimising fraud, and additionally offer on-going training to their staff and enforce policy integrity. The preparation of an organisational chart could assist with clause 21, by ensuring that policies are in place for the timely banking of trust funds. Also, if the Office of Fair Trading issued guidelines to assist with the interpretation of this clause, licensees would be able to implement these policies.

The problem with clause 25, could easily be rectified with the mandatory requirement that all trust receipts issued should show the date that the trust funds were actually received. Clause 26 could be improved with the additional requirement that if trust funds were invested, then a controlled money register for all investment funds were to be maintained. This requirement would also compliment clauses 30 and 31, where the controlled money register would also have separate ledger accounts, and a trial balance, all of which are independent from the ledgers and trial balance already maintained within the main trust account frame work.

Clause 28 could introduce a minimum requirement that the cash book should be balanced, for example, in intervals of no more than 5 weeks apart in any given time frame. Once this clause was amended, clause 31 could be modified to correlate the balancing of the cash book, with the preparation of the trial balance.

Clause 29 should be accompanied with the necessity to include paperwork legitimising the transfer of funds within the various ledgers; and clause 30 should be amended to clearly state that no ledger should result in a debit balance.

Below is *figure 5* is a summary of suggested recommendations relating to the problem areas identified within the legislation.

Figure 5

SUMMARY OF SUGGESTED RECOMMENDATIONS

CLAUSE NUMBER	SUGGESTED RECOMMENDATIONS
21	• Issue guidelines on the interpretation of the banking requirements and guidelines on an accepted practice to carry out the daily banking • Licensee should implement a code of conduct and implement the concept of self-audit
25	• Receipt to show date funds were received, and the date the receipt is being issued
26	• Licensee to keep a controlled money register for all funds invested
28	• Introduce a minimum requirement for when cash books should be balanced e.g. in intervals of no more than 5 weeks apart in any given time frame
29	• Introduce a document trail register for the transfer of trust funds within ledgers
30	• Amend legislation to clarify the debit balance • Introduction of individual ledgers for invested funds, plus the requirement of the controlled money register as mention in clause 26
31	• Introduction of a trial balance for all invested funds • Clarification of the due date for the trial balance to coincide with clause 28

Figure 4

In conclusion, the findings identified a number of problem areas with respect to consumer protection that called into question the adequacy of the current legislation. The paper concluded with suggestions and recommendations for improving the present regime and thereby enhancing client protection and consumer confidence with property agency.

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