The Finance Function

Today, one cannot try to identify a single business model for a real estate management office and its finance function. Rather, three or four general business models are refined into nearly as many permutations as there are companies in a given market. This provides for great flexibility as well as for market differentiation in terms of levels and costs of service.

REAL ESTATE MANAGEMENT COMPANY STRUCTURES

A real estate firm may have a management division, or a business may be established to engage solely in real estate management services to real estate clients. Both types of business are referred to as fee management firms—they charge clients a fee to manage their properties. In other situations, owners of sizable real estate holdings may have their own management divisions. Instead of being a client of a fee management firm, the property owner employs the real estate management staff, either directly or through a subsidiary company. These are referred to as in-house managers.

While real estate management offers great flexibility in terms of organizational structure, the profession is regulated through standards based on principles in the real estate brokerage, securities, and accounting professions. In some cases, standards are clearly defined by legislation; others, while not legally binding, are defined by local practice. Operational standards are sometimes set by company policy and sometimes by legal requirements. Properties that are financed by securities or owned by publicly traded companies may be subject to additional regulations set by federal law. Some standards are established by the real estate brokerage laws where the office or property is located. These laws may include accounting and financial reporting requirements. States may regulate the manner in which bank accounts are established along with establishing timelines for financial reporting. Real estate trust accounts are usually governed by state law. State laws also dictate some policies that must be followed in landlord–tenant relationships. Other standards are necessitated by financial reporting requirements in the ever-changing environment of securities and financial integrity regulations. The real estate manager must stay informed about all standards of the profession. Violations of any federal, state, or local laws and regulations are both illegal and unethical.
One important role of a real estate management company is to be a fiduciary, with the real estate manager acting as agent for the owner in handling the financial affairs for a given property. Being a fiduciary places obligation on the agent to report all funds that come into its possession on behalf of a real estate owner and to further report all expenditures. The manner in which this reporting is handled may vary among companies, but timely, accurate reporting is an ethical obligation and in many states a legal requirement. While there are no specific written industry standards for real estate managers, successful practitioners strive to operate their companies according to industry-identified best practices—norms for operation used by ethical and honest companies. Wherever possible, this text will address real estate finance and financial reporting consistent with defined best practices of the industry. An excellent tool for defining standard procedures for your company is *Best Practices: Real Estate Management Service*, published by the Institute of Real Estate Management (IREM®). IREM is a worldwide society of professional real estate managers and an affiliate of the National Association of REALTORS. The profession of real estate management, in addition to having identified best practices, is self-regulated. Standards of ethical conduct have been articulated by IREM, which confers the well-respected Certified Property Manager® (CPM®) designation to members who meet its educational requirements and subscribe to its Code of Professional Ethics. Other organizations, including but not limited to BOMI International, National Association of REALTORS® (NAR), and National Association of Residential Property Managers (NARPM), also confer designations that require adherence to strict standards of ethical conduct.

**THE ACCOUNTING FUNCTION**

A real estate management company’s success hinges on the strength of its major components, which can be compromised if the accounting department produces substandard work. Ineffective accounting can jeopardize a company’s earning ability as well as expose it to serious legal consequences. A successful and efficient accounting department generates quality financial statements, but it must do much more—it must carry out activities that support every aspect of the real estate management environment. Providing meaningful, understandable, and timely financial statements to property investment stakeholders month after month confirms a management company’s value.

It is imperative that the real estate management company establish, maintain, and update as needed an accounting system that supports company operation, is consistent with client directives, and complies with accepted accounting and financial reporting principles. The handling of client funds is accomplished through an accounting system that accommodates both the management company and the properties under its care. Accounting is generally defined as the practice of classifying, recording, and summarizing financial transactions. It is largely concerned with monitoring the flow of income and expenses in a business, accomplished through categories of debits and credits. In
a further refinement, short-term movements in accounts are monitored through accounts payable and accounts receivable. Financial accounting is a system of classifying financial transactions that documents the financial position of a given entity—either the management company or the properties under its management—in the form of a balance sheet and an income statement.

Client directives with respect to accounting systems can vary widely: Some institutional owners may provide the management company with an accounting procedures manual that sets forth all of the institution’s requirements; other clients may have less stringent, though no less important, accounting expectations. Any accounting system should support both cash and accrual accounting (see Chapter 4: Accounting Basics) to the extent that client reporting requirements dictate.

An accounting system can be provided through an in-house accounting department, or the accounting function can be outsourced. In either case, the management company is responsible for that system and its adherence to all accepted accounting and financial reporting principles.

In-House or Outsource

As mentioned, within a real estate management company, the accounting function can be handled in several ways. Depending on the firm’s size and in-house capabilities and the client’s needs, the company may handle all accounting functions on its own or may outsource to meet some or all of its accounting requirements. While use of an outside accounting firm might be prudent, many clients want the accounting function to be tightly controlled by the real estate manager. It is also common for real estate management companies to hire accounting firms or other management companies that have in-house accounting personnel to handle their accounting function. Examples 3.1 and 3.2 compare in-house and combination accounting approaches.

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<th>In-House Approach to Accounting</th>
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Multi-State Management is a regional real estate management firm that handles properties of all types in three states. Their in-house accounting department handles or supervises all functions, including accounts receivable, accounts payable, and preparing monthly statements for owners.

Multi-State Management also has a roving team of maintenance technicians who are invoiced to the properties they manage on a time and materials basis. The company maintains a separate maintenance billing department to invoice clients for maintenance services. While all functions are supervised by Multi-State’s accounting department, certain tasks are performed onsite at the offices of the managed properties.

Example 3.1
Chapter 3: The Finance Function

Combination Approach to Accounting

Bark River Company, a real estate management firm operating 1,000 residential apartment
units for three separate clients, uses its computer system to track occupancy and delinquency.
The Bark River employees deposit rent checks into the bank and record them in the software.
Invoices for property operating expenses are approved by the real estate manager and forwarded
to the in-house accounts payable clerk for processing and payment. By handling check
processing, the real estate managers can monitor and enforce collections on a timely basis, and
by paying the invoices in-house, the firm can track cash flow effectively.

However, Bark River contracts with Mid City Accounting to prepare the monthly statement of
operations for each of its three clients. Mid City Accounting accesses the records from Bark
River’s computer system, reconciles the bank statements, and prepares and mails the monthly
statements. Bark River feels this approach allows it to focus on the operational side of real estate
management while giving its clients high-quality and timely operating statements.

In many ways, a real estate management company operates several businesses. It operates each
property as a business entity separate from other properties and from the management company.
The company itself must also be managed as a profitable business. Its accounting department
must be organized to service all of these business entities. The management firm may have several
departments, including real estate management and administrative services, as well as centralized
maintenance in lieu of property-based maintenance personnel. In addition to the company’s general
bookkeeping of the firm, there may be a billing department that invoices properties for management
and ancillary services. Whatever the permutation, each real estate management company must put in
place a financial management strategy supported by knowledgeable personnel to handle accounting,
budgeting, and financial management.

Accounting Personnel

The number of employees who have accounting responsibilities will depend on the size of the
management company’s portfolio and the degree of reporting required by its property owners. If a
single bookkeeper focuses solely on accounting work, it is a good practice to train one or more others
to perform that work as a backup. Other staff members may be assigned to specific accounting
tasks on a part-time basis, but the costs of these personnel should be considered. Establishing
a professional connection with an accounting firm or a Certified Public Accountant (CPA) who
understands the management firm’s operations is one option for providing backup resources as
needed.

Example 3.2

Combination Approach to Accounting

Bark River Company, a real estate management firm operating 1,000 residential apartment
units for three separate clients, uses its computer system to track occupancy and delinquency.
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River’s computer system, reconciles the bank statements, and prepares and mails the monthly
statements. Bark River feels this approach allows it to focus on the operational side of real estate
management while giving its clients high-quality and timely operating statements.
Important accounting functions include full-charge bookkeeper, accounts payable, accounts receivable, and rent collection as described in the following chart.

<table>
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<tr>
<th>Position</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Full-Charge Bookkeeper</strong></td>
<td>In a small company, the accounting “department” may be a single full-charge bookkeeper who performs all of the accounting functions necessary to operate the managed properties in addition to keeping the books for the management company. One of the advantages to hiring a full-charge bookkeeper is that at least one employee generally knows the accounting system’s capabilities and fully understands the owner’s requirements for each property. A disadvantage is that this exclusive knowledge may place the employee in a position to manipulate the system dishonestly. This possibility can be averted by instituting a system of checks and balances; the bookkeeper’s work should be reviewed periodically to catch inadvertent errors and discourage dishonesty. If the bookkeeper writes checks, someone else in a position of authority, such as the company executive, should sign them. Invoices should be reviewed and approved by someone other than the bookkeeper, with no exceptions. On a regular basis, someone in authority should also review the bank account reconciliations and verify income items and compare them to the tenant records.</td>
</tr>
<tr>
<td><strong>Accounts Payable</strong></td>
<td>The accounts payable function should be assigned to an employee who can evaluate invoices, analyze them for accuracy, and make sure bills are not duplicated. An invoice should always be submitted for preapproval, along with the account to be charged, by the person ordering the product or service. Accounts payable personnel also check approved invoices for accuracy, discounts, and merchandise not delivered and prepare invoice payments.</td>
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Accounts Receivable

Accounts receivable personnel are responsible for receiving and recording the company’s income from management fees and other sources and for the income received directly from the managed properties. An employee responsible for the accounts received usually maintains the tenant records, works with lease summaries, and sends out monthly invoices for rent collection. She or he also logs in rent checks and ensures that residents and tenants have paid the correct amounts, monitors rent increases, tracks percentage rents, and prepares delinquency reports. Accounts receivable employees are generally responsible for making sure that all accounts are balanced and in agreement with the bank statements.

Rent Collection

In many companies that manage commercial properties, real estate managers are ultimately responsible for rent collection. The professional relationships they have established with tenants lay the foundation for them to assume this responsibility. For residential properties, the onsite manager typically collects rents. If a situation develops requiring legal action (such as an eviction), it is handled by other management company personnel. For smaller properties without onsite management, the real estate manager who supervises the property’s operations assumes responsibility for rent collections. Residents might also be given the option to mail rent payments to the management office, leave them in a secure drop box, or submit them electronically. Whichever option is used to collect rent, the collections should be the responsibility of one person to ensure that rent payments are handled properly, including immediately stamping checks “For Deposit Only” and ensuring they are promptly deposited.

ACCOUNTING DEPARTMENTS IN SMALL AND LARGE OFFICES

Technology has blurred some of the traditional divisions among administrative duties, and each real estate management company decides how to organize itself. Many companies have an operations division responsible for some administrative tasks while others are concentrated in the accounting department. The term **front office functions** is commonly used to refer to the real-time accounting functions that require interaction with tenants, residents, and vendors—including lease administration, enforcement, and rent collection. These functions largely take place during an accounting period rather than after it is closed, and in a multifamily property or a large office building, at a property’s onsite office rather than the real estate management company’s office. Computer technology makes it
possible to enter data at its most logical point of entry. Where front office staff are working directly at a property, the cost becomes a property expense, which helps prevent the confusion often associated with allocating and invoicing employee time when front office duties are performed in a central office.

The term **back office functions**, on the other hand, typically refers to accounting functions that do not require interaction with residents or tenants; they primarily address preparation of historical operating data after an accounting period is closed, payment of operating expenses for properties, and carrying out the operation of the management company. Even in cases where the front office accounting is performed onsite, the chief financial officer or accounting supervisor—each considered a member of the back office—is responsible for assuring that internal controls are being met and verifying all input data prepared at the front office.

Note that while there may not be a physical front and back office, especially in smaller offices, these terms are used to highlight the different types of functions within an account department.

Though probably no two real estate management companies organize their accounting departments identically, most handle basic functions in the same way. Large firms may have multiple employees that work together to serve single functions, while smaller firms likely combine functions under management of a single individual. Some departments may be easily scaled down to meet the needs of a smaller firm by combining duties, but real estate managers should be aware that scaling down too much may prohibit adequate internal controls, which, among other objectives, require certain duties be performed by separate individuals.

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**Centralized vs. Decentralized Input and Processing**

Centralized input and processing occurs when a site manager at a residential property, for example, would fax or e-mail a completed tenant application to the home office where the credit screening would be done and the lease prepared. Then, in all likelihood, the tenant would have to mail their check to the home office where it would be processed and applied to the property owner account. The site manager would receive daily or weekly reports of “who lived where” and also lists of delinquencies—all of which would be generated by a central office. Additionally, paying invoices usually requires an invoice go to the central office, then sent to the site office for initial approval, and finally back to the central office for processing and payment.
Centralized vs. Decentralized Input and Processing (continued)

A totally decentralized system begins when the site manager enters the tenant’s information into a module of the computer system. That same information would transfer to partially fill out the application form, which could automatically generate the credit report. If approved, the same data would be automatically entered into the lease document where it would be printed out onsite—obviously with some approval levels from a regional manager. In addition, the site manager may accept and process checks even to the extent of scanning the check and handing it back to the tenant. The site manager can print their own reports of occupancy and delinquency as well as mail/email notices to tenants where appropriate. Accounts payable could be ‘routed’ from the site through the approval process.

From a financial perspective, what this does is push the cost of all this processing from the central office (which is usually paid for as part of the management fee) to the site office (which is usually paid for by the property owner). It is also considerably more efficient if the proper internal controls are in place.

ACCOUNTING REQUIREMENTS BY PROPERTY TYPES

The type of property under real estate management influences the specific needs for accounting services. For example, rental apartments and condominiums may have many of the same accounting needs, but offices, industrial parks, and retail properties present new considerations and challenges.

Rental Apartments

Rental apartments have fairly simple requirements for accounting. Differently from commercial properties, apartment owners are generally responsible for maintaining apartment interiors as well as the building as a whole, so operating expenses are usually higher as a percent of income. The major source of property income is normally monthly rents; often owners also charge separate fees for swimming pool, fitness center, or parking, such income items must be tracked separately.
Condominiums

Condominiums likewise have fairly simple accounting needs. The income consists almost entirely of monthly assessments collected from the owners, and these usually change only once a year. Because owners maintain their individual homes and pay their own property taxes, the only expenses are for maintenance of common areas and operations (e.g., laundry, internet services). An office condominium might account separately for pass-through of some building operating costs to the occupants, but this situation is rare.

Office Buildings and Industrial Parks

Accounting requirements for office buildings and industrial parks are a little more complex than for residential space, in that building operating costs, known as Common Area Maintenance (CAM) expenses, are almost always passed through (billed back) to the tenants. This requires preparing a budget each year, billing tenants an estimated amount each month, reconciling the estimated amounts with actual figures at year’s end, and billing or crediting tenants for the difference. Examples of other additional charges that may be incurred by a tenant through the normal course of their occupancy include air conditioning, parking, or office maintenance services. If an office building includes ground-floor retail tenants, their leases may require payment of percentage rent, an amount that varies from month to month.

Shopping Centers

Shopping centers have the most complex accounting needs of managed properties. In addition to pass-through charges—including operating costs, common area maintenance expenses, property taxes, and insurance—there is the added element of percentage rent. Charging percentage rent requires collecting and analyzing sales reports and billing tenants accordingly. A shopping center may also have marketing funds for which they must account, such as holiday events.

... when considering the accounting function and requirements for his or her company:

- How is the accounting function handled in my company? Is this effective?
- Are there ways the accounting function can be improved?
- How better might my company staff its accounting department to ensure efficient and effective processes?
ESTABLISHING FINANCIAL POLICIES AND PROCEDURES

Much of the success of a real estate management firm is rooted in the policies and procedures established by the accounting department, under the supervision of the real estate manager: dependable administrative procedures, timely reporting to owners, safeguarding client funds, accurate billing, and supervising all staff administrative procedures. Accounting departments that practice disciplined administrative procedures allow real estate managers to focus on the operational issues impacting the success of their properties.

Among the many functions of the accounting department, none is more important than handling funds. Because monies belonging to clients are received and paid in the name of the managed property or its ownership, specific policies and procedures for handling receipts and disbursements are imperative. Supervision of any personnel who handle funds is a primary safeguard. This especially may be needed in smaller companies that have a single bookkeeper. Financial responsibilities are generally assigned so that one person collects funds, but another makes up the bank deposit. Payments are approached similarly: When an invoice is received, one person approves the payment and another prepares the check. A third person often actually signs the check, and when possible, yet another puts the check in the envelope to be mailed.

Once established, the internal controls must be applied to the handling of the company’s financial transactions as well as those of its clients. Strict adherence not only minimizes problems within the accounting function, it also helps assure that very few problems will be uncovered in any performance audits clients may request.

Internal checks and balances reduce the possibility of theft or misappropriation of funds and minimize the potential for accounting errors. Most management companies institute an internal audit system in which a supervisor reviews prior transactions for irregularities. For example, if an unusual charge shows up, the supervisor questions those who approved the expense and may even contact the vendor to determine what product or service was provided (and, when applicable, how it applies to a specific property). If the staff’s answers are satisfactory, the audit is considered closed. If not, the supervisor continues investigating until satisfaction is achieved or the problem has been corrected or eliminated.

In most companies, authorization to sign checks for the business is limited to the principal (the business owner), the executive responsible for accounting and finance (the controller), and an accounting supervisor. Authorizations to sign, as well as dollar limitations and situations requiring more than one signature, are on record at the bank holding the account. (Typically, checks exceeding a particular amount require two signatures; this reduces the chance for error and averts the potential for misdirection of funds.)

Chapter 3: The Finance Function
If the real estate management company establishes accounts for clients, checks may require the signature of a company executive or, in some cases, a representative of the client. Accounting personnel need to know who is authorized to sign checks for company and client accounts and to understand the limitations on individuals’ signatory authority. Many real estate management companies and owners now use accounting software and online banking features that allow for electronic signature authorization, online payments, direct ach (automatic clearing house) payments, and other electronic banking functions. In addition, owners may own and pay for accounting systems used by the real estate management company. With the increased use of these electronic and virtual tools and functions, it becomes more difficult for the real estate management company to monitor controls. However, it is still imperative that controls be put in place to ensure ethical management and protection of funds.

**ETHICAL MANAGEMENT AND PROTECTION OF FUNDS**

Handling clients’ funds requires insurance to protect them. Most management agreements oblige the real estate management company to provide a fidelity bond in an amount sufficient to cover the largest balance of client funds that the company is likely to have on hand at any time. Regular electronic transfers of money to clients can reduce the funds on hand and lower the amount of the fidelity bond needed. A large management company may employ an internal auditor as an added safeguard.

Real estate management firms must maintain strict separation of the accounting duties required for property management and those needed by the firm. Special care must be taken to avoid commingling, which is the deliberate or accidental combining of funds of several real estate owners or of property owner funds and the management company’s funds. Commingling of funds is illegal in many states, and it is a violation of IREM’s Code of Professional Ethics, which requires real estate managers to hold propriety information in confidence, to maintain accurate financial and business records for the managed property, and to protect owners’ funds. Note, in those jurisdictions where it is not illegal to commingle accounts, real estate management companies must disclose to their clients that all funds are in a single account. Also, cash in and cash out must be accounted for by owner or property and disclosed accordingly. In areas where commingling is not illegal, real estate management firms may be tempted to commingle client funds to earn interest or credits because the recipient of these would be the real estate management firm. However, even in jurisdictions where commingling of funds is allowed, it is illegal for a real estate management firm to make money from the commingling of funds unless the situation is disclosed to and approved by the client. At no time should a management company’s funds be commingled with the property owner’s funds.
The client will almost always designate the types of bank accounts to be maintained, although the choice of institution may be left to the manager. This issue is typically addressed in the management agreement. Usually two bank accounts are maintained by the accounting department for each property or each client. One is a **disbursement account**, from which expenses are paid; the other, which bears interest, is a **deposit account**, used as the repository for all income. Typical procedure is for a batch of invoices to be collected periodically, such as once a week, and money transferred from the client's deposit account to the disbursement account, against which payment checks are written. Sometimes a client retains the right to remove excess funds from the deposit account electronically.

Whatever the details of the client arrangement, a real estate manager is likely to work with two other basic types of accounts: **trust accounts** and **agency accounts**.

**Trust Accounts**

The typical trust account is set up by the real estate broker or real estate manager on behalf of the client. The **broker** and/or the broker's designated personnel are the only signatories on the account, which is subject to very strict state regulation. Clients sometimes ask to be signatories on trust accounts, but such an arrangement should not be allowed, as it might jeopardize the broker's standing with state agencies. A client's funds should not be commingled with any others. Any interest earned belongs to the client (unless specified otherwise in the real estate management agreement), and all funds must be fully accounted for at all times—funds cannot be held outside the account or borrowed by the real estate manager against future fees without client approval.

In most states, a state representative audits trust accounts routinely, and disciplinary action can be taken if discrepancies are discovered. Depending on the severity of an infraction, the action may be only a letter demanding compliance with account requirements, or it could be as severe as suspension or a loss of license for the broker. Each real estate manager taking on responsibility for a trust account must determine state-specific requirements, which may be more exacting than the client's.

**Agency Accounts**

An agency account serves a similar purpose as a trust account, without the same state requirements. The real estate manager still has a fiduciary responsibility to the client to handle funds prudently. An agency account is generally set up with the same stipulations as a trust account, except that the client is often an additional signatory. While the client can withdraw funds from the account at will, typically this is not done without consulting the real estate manager about the operational funds required.
... when considering his or her company's financial policies and procedures:

- Does my company have financial policies and procedures in place to ensure ethical financial management and protection of funds?

REVIEW QUESTIONS

- Describe one important role of the real estate management company.
- Describe some factors that differentiate fee management companies from in-house management?
- What are the key accounting functions within a real estate management company?
- What is the difference between centralized and decentralized input and processing?
- How might accounting requirements differ by property?
- Why is establishing financial policies and procedures imperative?
- What is commingling of funds and why is it considered unethical?
- What are two ways to protect funds from being commingled?