

# **THEME: THE BANK RECONCILIATION**

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## **ACCOUNTING TERM: Bank Reconciliation**

The bank reconciliation is a process by which to compare an entity's book cash balance with the bank's cash balance as of a given period so as to note any discrepancies.

## **FEATURE ARTICLE: The Bank Reconciliation – Your Most Important Navigational Tool.**

What person would attempt to sail across the ocean without a compass, map, and a sextant? These are traditional navigational tools without which one could easily lose one's way. In accounting, the bank reconciliation serves the same navigational purpose. Here's why:

Cash is the lifeblood of a business organization. With it you succeed, without it you fail. Cash is so vital to an organization that one must continually keep track of its flow in and out of a business. This flow of cash is analogous to the pulse beat of a human heart. Some businesses check this pulse hourly, some daily. This is usually done via the running check register balance. Deposits are added, checks are subtracted to find the current cash balance.

Because we know that life is not perfect, mistakes are made. In order to find these mistakes, we need to have something from which to compare our calculations. Since we deposit and withdraw our money from a bank we can compare our records to theirs, hence, a "bank reconciliation". Once we have done this we can be reasonably assured that our current check register balance is correct. This is important, because we need accurate information for planning purposes. For instance, can I afford to buy those supplies? Will I have enough money to meet the payroll this week?

Admittedly, some people run their businesses by the "seat of their pants". I know individuals who call the bank everyday to find out what their cash balance is. However, this method has a fatal flaw called "outstanding checks". You may have written checks that the bank hasn't yet received. What happens when those checks hit the bank? You had better have enough deposits to cover them. This is not a good way to run a business.

The bank reconciliation is the heart of your business bookkeeping. It brings light where before there was darkness. It brings order where chaos could potentially reign. Once completed, its power lies in the fact that you now know exactly how much money was deposited in the bank and where that money came from. In

addition, there is no guessing as to exactly how much money was withdrawn and for what purpose. It provides a document that you can easily refer to for writing adjusting journal entries. This means you have a clear-cut audit trail that shows where your cash activity originated and how it arrived on the general ledger.

Once you have reached this point in the process of preparing your financial statements you are pointed towards home and the remaining items are usually routine. Those who have tried to prepare financial statements without the bank reconciliation as a guide understand and appreciate what I am talking about.

Are bank reconciliations difficult to prepare? It depends on the complexity of your business. Most small business bank reconciliations are fairly straight-forward. However, there are a variety of mistakes that can sometimes throw you for a loop. Here are eleven of them:

#### **Book Side:**

- 1] Beginning balance is incorrect.**
- 2] Deposit totals are incorrect.**
- 3] Check register total is incorrect**
- 4] Some bank charges on the bank statement were unaccounted for.**
- 5] A transposition error occurred.**
- 6] There was an addition or subtraction error.**

#### **Bank Side:**

- 7] The bank's beginning balance was not recorded correctly.**
- 8] A last month's deposit-in-transit was not taken into consideration.**
- 9] This month's deposit-in-transit was not included.**
- 10] An outstanding check is not actually outstanding.**
- 11] A check that is outstanding is not recorded as outstanding.**

However, there are techniques you can learn to catch these mistakes. I list ten in the Real Life Accounting course, but it really boils down to developing a system of looking for the obvious first and then systematically eliminating possibilities.

The great thing about a bank reconciliation is that it *has to* balance. There is always an eventual solution. You are never left in a state of limbo.

It is important to be organized when preparing a bank reconciliation. I create a manila folder that is labeled with the name of the company and current year. I use a two-hole punch and acco-fasteners to secure the bank statement and the bank reconciliation form to the folder. This way, the information does not get misplaced.

Being organized paid off for me last week when I had to represent one of my clients in an IRS audit. IRS agents always want to see how you arrived at gross receipts. All I had to do was to pull out my manila folder containing the bank statements and bank reconciliation form organized by month. Very easily I could show the agent how the deposit figure from the bank statement tied into the deposits on the bank reconciliation and my journal entry posting the amounts to sales. He carefully listed each amount on a ledger page, added them together, and, sure enough, the total was the exact amount he was looking for on the tax return. Audit over! That felt good. Without a system, that experience could have been a nightmare.

When I work on a set of books for a client, the first thing I do is the bank reconciliation. You should do the same. Once you experience how everything falls in place when navigating with this powerful tool, you will never go back to the old way.

### **Question: What is a Deposit-in-Transit?**

To answer this question you have to think about what you are trying to accomplish when preparing a bank reconciliation. There are two sides to consider, the book side and the bank side. The goal is to reconcile activity that occurred on both sides with each other. Therefore, if you recorded a certain number of deposits during the month on your books, but the bank didn't, then you have to add those deposits to the bank side of the bank reconciliation. This can happen if the deposits you made at the end of the month were on a Friday and the month ended on the weekend. Then the bank would record your deposit on the following month's bank statement. Therefore, we would say that those deposits that you recorded, but the bank didn't, are "in-transit".

On your next month's bank reconciliation you would check them off as having already been counted in the prior month.

It is the same for "outstanding checks". You may have written the checks during the current month but they weren't cashed until the following month or later. Therefore, you must subtract the total of those checks from the bank side in order for your books to reconcile with the bank statement.

**TIP: Why You Should Not Prepare a Bank Reconciliation on the Back of Your Bank Statement.**

Preparing your personal bank reconciliation on the back of your bank statement will work just fine, but your business requires more information. Such as:

- Where your deposits came from.
- The amount of your total checks written.
- Bank charges.
- Non-sufficient funds.
- Special bank debit or credit memos.
- Automatic deductions.
- Stale-dated checks.
- Voided checks.
- Deposits-in-transit.

On the back of the bank statement is room for outstanding checks and that's about it. This also holds true for computerized bank reconciliations. The computer bank reconciliation report shows the totals, but, no detail. It then becomes useless as a reference document. It shows you are balanced and all you can do is hope it is right. For me, it is not enough. I like knowing exactly why my cash balance is correct. I use the bank reconciliation as a source document that not only tells me where my cash came from and where it was spent, but, also as a means of providing the information necessary to write general journal entries. Look at the following example of a bank reconciliation form:

**BANK RECONCILIATION FORM**

**Date Completed: 8/7/XX**  
**By: John Day**  
**Name of Company: T-Shirts Forever**

**For Period Ending: 7/31/XX**  
**Bank: National Bank**  
**GL Account #: 1010**

**BOOK:**

**Beginning Balance:** **\$ 500.00**

**Add Deposits, Etc.**

<b>T-Shirt Sales</b>	<b>GL#4010</b>	<b>\$3,000.00</b>
<b>Interest Income</b>	<b>GL#6710</b>	<b>\$ 3.25</b>
<b>Insurance Refund</b>	<b>GL#6830</b>	<b>\$ 25.00</b>
<b>Owner's Contribution</b>	<b>GL#3550</b>	<b>\$ 500.00</b>

**Subtract:**

<b>Cash Disbursements:</b>	<b>GL#Various</b>	<b>\$ 1,500.00</b>
<b>Bank Charges:</b>	<b>GL#6210</b>	<b>\$ 20.00</b>

<b>Auto Deductions:</b>	<b>GL#6430</b>	<b>\$ 100.00</b>
<b>Other:</b>		
<b>NSF check #2778</b>	<b>GL#4980</b>	<b>\$ 35.00</b>
<b>Payroll transfer</b>	<b>GL#1020</b>	<b>\$ 1,250.00</b>
_____	<b>GL#_____</b>	<b>\$ _____</b>
_____	<b>GL#_____</b>	<b>\$ _____</b>

**Ending Book Balance** **\$ 1,123.25**  
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**BANK:**

**Ending Bank Balance from Statement:** **\$ 2325.00**

**ADD:**

<b>Deposits in Transit</b>	<b>\$ 200.00</b>
<b>NSF Checks:</b>	<b>\$ _____</b>
<b>Other:</b>	
_____	<b>\$ _____</b>
_____	<b>\$ _____</b>

**SUBTRACT:**

<b>Outstanding Checks</b>	<b>#</b>	<b>\$ 1,401.75</b>
<b>Other</b>	<b>_____</b>	<b>\$ _____</b>

**Reconciled Ending Balance:** **\$ 1,123.25**  
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Under deposits on the book side it is very clear that I received \$3,528.25 in cash for the month ending July 31. I know exactly where it came from. The sales of T-Shirts, an insurance refund, a little interest earned from the bank, and my own contribution of personal cash. Now all I have to do is write a journal entry that will get posted to the general ledger. Once all the transactions are posted to the general ledger the computer can automatically generate a financial statement. Here is how my general journal entry would look. Compare the numbers to the bank reconciliation and you will see how simple this process really is.

DESCRIPTION	DEBIT	CREDIT
Cash	3,528.25	
T-Shirt Sales		3,000.00
Interest Income		3.25
Insurance		25.00
Owner's Contribution		500.00
To record deposits received during July		

It works the same for the withdrawals:

<b>DESCRIPTION</b>	<b>DEBIT</b>	<b>CREDIT</b>
Bank Charges	20.00	
Insurance (auto deduct)	100.00	
Returns & allowances	35.00	
Cash – Payroll account	1,250.00	
Cash		1,405.00
To record cash withdrawals for July		

What about the \$1,500.00 in Cash Disbursements? That figure represents the total amount of checks written for the month. No adjusting journal entry is required because when the checks are written they are either posted automatically to a Cash Disbursements Journal or they are posted manually to the Cash Disbursements Journal at a later date.

The mystery is gone. If someone challenges you to prove a balance, you will not feel insecure and unsure. You will feel the power and confidence that comes from knowing exactly how your book balances came to be.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.