

BANK RECONCILIATION

RELEVANT TO CAT PAPER 3

A question on bank reconciliation has frequently been included in past CAT Paper 3 exam papers and this can be expected to continue. While many candidates pick up a high number of marks on this topic, a number of candidates do not perform well. This could easily be corrected by applying clear thinking to the question. This article sets out the key issues to be considered in the context of the *Study Guide* outcomes for CAT Paper 3, *Maintaining Financial Records*.

PURPOSE OF A BANK RECONCILIATION

To understand the purpose of a bank reconciliation, it is necessary to consider the overall purpose of CAT Paper 3. Financial records are maintained so that final accounts can be prepared. Given that the overriding requirement of final accounts is that they should fairly present the financial position and income and expenses of the entity, it follows that the underlying financial records must be reliable. This means that all transactions should be recorded accurately.

Therefore, the purpose of a bank reconciliation is to ensure that the underlying records relating to bank transactions are reliable. This means that the completion of a bank reconciliation is more than a matter of arithmetical accuracy. It is not sufficient to provide a statement which reconciles the balance on the bank account in the entity's ledger and the bank statement. Rather, it is important to ensure that the ledger balance is correctly stated, by making any correcting entries in the ledger, so that the corrected ledger balance is reconciled to the bank statement balance. This is emphasised in the *Study Guide* for CAT Paper 3. Outcome 12 (e) is deliberately worded as follows: 'Prepare a reconciliation between the statement balance and the corrected ledger balance'.

Thus, the purpose of a bank reconciliation is to check the accuracy of the bank balance in the entity's ledger and to ensure that the bank balance is correctly reported in the final accounts.

REPORTING THE BANK BALANCE

From the discussion above, it follows that the bank balance to be reported in the final accounts is the corrected ledger balance. If the corrected balance is a debit balance, then the entity will have funds at the bank which should be reported on the balance sheet as a current asset. If the corrected balance is a credit balance, then the bank account is overdrawn. This should be reported on the balance sheet as a current liability.

PROCESS

The process of carrying out a bank reconciliation is to compare the two sets of records (the entity's ledger and the bank statement) and to identify any differences. The vast majority of transactions will be present in both sets of records, but inevitably there will be differences. These differences will typically be the starting point for an exam question. The exam task is therefore to decide how to treat each difference. Perhaps the easiest way to do this is to consider the reasons for differences.

Timing differences

These are the most straightforward differences, as they are simply transactions which are recorded in each set of records in different periods. They arise because the entity will record the issue of cheques or lodgements to the bank at the point at which the transaction is initiated. However, the nature of the banking system may lead to a delay in a cheque being presented at, or a lodgement being processed by, the bank.

These differences are simply reconciling items. Therefore, no entry is required in the ledger, but such items should be included on the reconciliation statement.

Transactions initiated by the bank

There are a number of reasons why the bank may initiate a transaction. The most obvious is that the bank may have charged fees or interest, or may have paid interest to the entity.

A less obvious type of transaction initiated by the bank occurs when a cheque lodged by the entity is not honoured by the paying bank. In such circumstances, the bank will initiate a debit on the bank statement to cancel the lodgement, and a further debit charge for costs incurred by the bank.

Usually, the entity will not be aware that such transactions have occurred until the bank statement is received. If the final accounts are to be reliable, it is essential that these transactions are recorded in the entity's ledger, and are included in the corrected bank balance. Therefore any transaction initiated by the bank will require an entry in the ledger account.

It is worth remembering that the bank statement is actually a copy of the record of transactions maintained by the bank. This means that transactions are recorded from the perspective of the bank. Therefore a lodgement will appear on the bank statement as a credit entry, as it increases the liability of the bank to the account holder. In the books of the account holder, a lodgement will be a debit entry in the bank account on the general ledger. In the same way, cheques issued, bank charges, and bank fees will appear on the bank statement as debit entries, and will be recorded in the bank account in the general ledger of the account holder as credit entries. As a result, a balance at the bank will be a credit balance on the bank statement, and a debit balance on the bank account in the account holder's general ledger.

Transactions omitted by the entity

Obviously, if a transaction has been omitted, then an entry must be made in the ledger to ensure it remains reliable. The nature of the entry will depend on the type of transaction which has been omitted.

Transactions incorrectly recorded

These are probably the most difficult matters to deal with. The first question to be considered is whether the error has been made by the entity or by the bank. If the error has been made by the entity, an entry must be made in the ledger. If the error has been made by the bank, an adjustment will be included on the reconciliation statement.

In both cases, the value will be the net effect of cancelling the incorrect entry and establishing the correct entry.

PAST PAPER QUESTION

Perhaps the best way to illustrate how to handle a bank reconciliation is to consider a question from a past paper. The following question was in the June 2007 CAT Paper 3 exam:

At the end of each month, Sarah prepares a bank reconciliation statement for her business bank account. At 31 May 2007 her ledger balance was \$2,759 (credit) and her bank statement showed that she had funds of \$131 at the bank. She has the following information:

- (i) The bank debited Sarah's account with charges of \$129 during May. Sarah has not recorded these charges.
- (ii) Sarah arranged for \$2,500 to be transferred from her personal bank account into the business bank account. The bank made the transfer on 30 May, but Sarah has not made any entry for it in her records.
- (iii) On 22 May, Sarah withdrew \$100 cash which she did not record.
- (iv) Cheque number 543987, which Sarah issued to a supplier, appears on the bank statement as \$650. Sarah incorrectly recorded the cheque as \$560.
- (v) On 31 May, Sarah lodged \$457. On the bank statement, this amount is dated 3 June.
- (vi) Sarah was advised by the bank that she earned \$52 interest for the period in May that her account was in credit. Sarah recorded this in May, but the bank did not credit her account until June.
- (vii) Three of the cheques issued in May, with a total value of \$942, were not debited on the bank statement until after 31 May.
- (viii) A cheque for \$276, issued to a supplier, was cancelled but Sarah has not recorded the cancellation of the cheque.

Required:

- (a) **Show the bank account in Sarah's general ledger, including any adjusting entries required due to the information given in points (i) to (viii).** Note: You MUST present your answer in a format which clearly indicates whether each entry is a debit or a credit. (7 marks)
- (b) **Prepare a reconciliation of the bank statement balance to the corrected balance on the bank account in Sarah's general ledger.** (5 marks)
- (c) **Indicate how the bank balance will be reported in Sarah's final accounts, and the value to be reported.** (3 marks)

(15 marks)

Before starting the question, it is worth considering the significance of the note included in requirement (a). As this paper tests candidates' ability to maintain accurate financial records, it is not appropriate for ledger information to be presented without clearly identifying whether a debit entry or a credit entry is being made. This can be done in a number of ways, but the use of 'plus' and 'minus' is NOT acceptable within a ledger account.

Approach

To complete the question, it is necessary to decide how each of the differences noted in the question should be treated.

Difference Treatment

- i The charges made by the bank need to be included in the ledger. A credit entry for \$129 is required in the bank account (the corresponding debit will be in the expense account for bank charges).
- ii This is an example of a transaction omitted from the ledger. As the transaction was to transfer the sum of \$2,500 into the business bank account, a debit entry is required in the bank account (the corresponding credit will be in Sarah's capital account, to reflect the funds introduced to the business).
- iii This is another transaction omitted from the ledger. In this case, funds have been withdrawn, so a credit entry for \$100 must be made in the bank account (the corresponding debit will be in Sarah's drawings account).
- iv The information confirms that the cheque has been incorrectly recorded in the ledger. Therefore, the value is understated by \$90. This means that the value of the cheque issued must be increased by \$90, leading to a credit entry in the ledger account (the corresponding debit will be in the trade payables account).
- v This is a timing difference. The lodgement is correctly recorded in Sarah's ledger, but the banking system means that it has not yet appeared on the bank statement. This will be an item on the reconciliation statement. It will lead to an increase in the funds at the bank.
- vi As the interest was earned during May, it has been correctly recorded in the ledger account in May. Therefore, it is another timing difference, and as such, should be included in the reconciliation statement.
- vii Cheques which have not yet been processed by the bank are timing differences, and will appear on the reconciliation statement. The effect is to reduce the funds at the bank.
- viii This is a transaction omitted from the ledger. When the cheque was originally issued, a credit entry would have been made in the ledger account. Therefore, to cancel the cheque a debit entry is required for \$276 (the corresponding credit entry will be in the trade payables account).

Having identified how to treat each item, the ledger account and the reconciliation statement can now be prepared. (Note, the explanations given

