Are Your Account Reconciliations Accurate?

By Jeff Adler, CPA

All accounting systems require processes and procedures to make sure information is received and processed on a timely basis, recorded accurately, approved as designated in company policies, and finally recorded in a database that's used to create meaningful financial and managerial accounting reports. The major enterprise resource planning (ERP) systems do a great job of providing a vehicle to record these transactions very efficiently.

But despite all the automated systems and routines that have been developed over the years, there's still one basic step that verifies all is well—the month-end account reconciliation. If you're concerned about accurate interim reporting, you should be preparing and reviewing these important control reports each month. For sure your external auditors will rely on these and test them extensively when certifying your financial statements. Part of their testing will not only include whether the reconciliations were prepared properly but also whether they were prepared on a timely basis.

In order to know that an account reconciliation is correct, you first have to know what an account reconciliation is. Many times I've been told that recent accounting graduates just don't understand what a reconciliation is. They may be good with the "accountant tool box" (Excel, PowerPoint, Word, GL/ERP applications), but they don't have a feel for what makes up a good reconciliation. Here's the definition I use:

Account Reconciliation: *a report that assesses the validity, correctness, or appropriateness of an account balance at a specific point in time—documented by relevant calculations, clear and complete explanations, and copies of supporting documentation—and that is consistent with the company's policies and procedures.*

Major Components

I know that's pretty long, so let's break it down into the major components.

1. Report. Your reconciliations should be in the form of a clear, concise report that leads the reader/reviewer through the process of how the account balance is determined and what was done to substantiate the balance. The reconciliation is a communication tool, and it's important to remind your preparers of this goal in reconciliation documentation. While it's important that the reconciler understands that the account balance is correct, the reconciliation should provide appropriate explanations and evidence so someone else can arrive at the same conclusion—that the account balance is correct.

2. Account balance. This is the easiest part of preparing a reconciliation—the end-of-the-month balance that's in the general ledger. One thing I find surprising, though, is how many reconciliations don't clearly state that the report agrees with the general ledger. It's also important that the reconciliation agrees with the *final* general ledger account balance. Have you ever had a reconciliation that was completed and agreed to the account balance—and then a post-closing entry was made that didn't get reflected in the reconciliation? What did you do then?

3. Relevant calculations. Each account has a different reason for being in the general ledger, and the calculations to support that balance will differ depending on the account. The calculations should clearly show the variables and constants that make up the total and the sources of that information. There should also be a complete description of the constants and variables that make up the calculation—and the source of that information. For example, the Allowance for Doubtful Accounts may be calculated by using certain predetermined percentages (constants) along with the amounts from the various aging buckets in your Accounts Receivable Aged Trial Balance (variables).

4. Complete explanations. Every item in a reconciliation should have a clear explanation of what it is and how it relates to the account balance. An explanation that says "JE-23" doesn't help anyone know what that specific item is and why it's appropriate to include in the account balance. It's important to remind the preparer of the reconciliation that not everyone knows what he or she knows. The explanations must stand on their own—complete and thorough. An explanation that says "Invoice 4539—James Realty—assessment of common occupancy costs—not recorded in Accounts Payable at month end" is much better than "Accrue unpaid invoice."

5. Supporting documentation. In order to review a reconciliation, the documents that show the amounts used in the calculations must be identified clearly, and copies of those documents should be filed with the reconciliation. If the preparer had to look at a document to understand that it was included appropriately in the account balance, then a reviewer of that reconciliation also needs to see that document. Remember, the reconciliation must stand on its own, providing complete evidence to a "third party" that the balance is correct. Documents can be period specific, like a month-end report, or item specific, like an invoice.

6. Consistent with policies and procedures. Your company policies and procedures should be easily accessible so the preparer can refer to them as necessary to make sure the accounting is in compliance with them. If a preparer doesn't know the company policy for accounting for certain transactions, how can he or she possibly make a statement that the items are included correctly in the account balance? Procedures for how to prepare a certain account reconciliation also must be documented. What reports are needed, where do they come from, what's the purpose for the account existing at all? This knowledge must be available to provide smooth transitions if there's staff reassignment or turnover.

Control Criteria

If you do all the steps noted above, you'll have a good account reconciliation process in place. Now let's add some important criteria that make this process a key control for your company.

1. Documented completion and review of the reconciliations. You must have evidence that the reconciliations were prepared and reviewed on a timely basis and that there's segregation of duties: The reviewer and the preparer can't be the same person. As with all controls, it isn't enough to "say" you do something—you must provide proof that you do something.

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2. Management reports to allow you to make sure the reconciliations are completed on a timely basis as part of your month-end closing procedures. Having a good reconciliation process is more than just giving instructions to your preparers. You have to manage the process with timely examination of the process to make sure the reconciliations are being prepared and, if they aren't, to direct action that will correct the problem.

3. Ability of you and your auditors to determine that this process takes place regularly and can be relied upon as a key control. This comes back to the requirement that you "prove" what you're doing—not just "say" what you're doing.

Controlling the Process

So how do you accomplish the task of making account reconciliations an integral part of your company's key control process? Here's an example from a large multinational company. Their objective was to make the reconciliation process a key control for accurate financial reporting and something the external auditors could rely on in attesting to the adequacy of those key controls.

What Were the Problems?

Because this company had no standard reconciliation formats or a regular process of making sure reconciliations were prepared, the whole process relied entirely on each local individual division controller. There was a requirement to fill out a representation letter every quarter that reconciliations had been properly completed and reviewed, but there were no clear instructions about what that meant. In divisions where the controller had a strong background in general accounting, the reconciliations were generally prepared consistently and correctly. In divisions where the controller had more of a financial analysis background, the reconciliations often weren't prepared properly—if at all. And there were no resources readily available to correct the problems of poorly prepared reconciliations.

Because the reconciliation process was handled in a decentralized manner, there was no ability for senior management to provide oversight. Also, the topic of account reconciliations wasn't something that would come up in the course of regular discussions with local management about the results of operations. Occasionally a questionnaire or e-mail would inquire about the process, but there was no ability to easily follow up and actively manage the process with real-time information.

This resulted in extra year-end audit-validation work by the external auditors. In addition, given the requirements of the Sarbanes-Oxley Act (SOX), the company possibly could have received a qualified opinion regarding internal controls. Both of these situations are costly: the first in actual dollars and cents for auditing fees and the second in the unknown cost of lack of credibility because of the inability of your auditors to attest to the proper existence of internal controls. An adverse opinion regarding the adequacy of internal controls over financial reporting can have significant repercussions related to the value of company stock (read: values could go down).

Though it's important to control external reporting, there's one significant additional risk if you don't have a good account reconciliation process. If your underlying financial records don't reflect correct account balances, your internal financial reports will be wrong—and your management team will be making business decisions using bad information! Beating the competitors is hard enough without the extra strain of trying to do it if you lack good internal information.

How Was a Good Account Reconciliation Process Put in Place?

The company installed software designed specifically for complete and accurate preparation of account reconciliations along with the ability to control and monitor the process.

The company uses six separate reconciliation templates to make sure it gathers the correct information for the appropriate reconciliation. This way the preparer can focus on the content of the reconciliation, not the form of how to report the information. Because these templates are hard coded in the program, there's no possibility of a mathematical error. (There have been a number of articles written recently about the risks of the Excel workbook and the possible errors that may come up, so I won't address that specific risk here.)

Each step of the reconciliation process is electronically documented: prepared/approved/reviewed. User IDs and passwords are the control that allows the staff to document their involvement in the process. With appropriate access to the database, supervisors and managers can perform their tasks without having to physically obtain the reconciliation from the preparer. All supporting documents are stored with the reconciliation and can't be edited. This is a true enterprise level of control over the complete process.

Company policies and procedures are documented and accessible. The preparer and reviewers can easily check to make sure the accounting activity complies with company policies. Reconciliation procedures assist with any transfer of knowledge that's required when staff members change because of transfer, turnover, or simply temporary illness.

Management reporting from the database gives managers and supervisors the ability to view the overall status of all reconciliations in real time with just a few mouse clicks. There's no need to "ask around the office" to see how things are coming along. Simply run a report, and follow up on the accounts that haven't been completed yet.

You can also run reports to show how individuals have done during any accounting period in completing their reconciliations on time. This information can be valuable when having meaningful conversations during an employee's annual performance review. It can also be used for monitoring a new employee or one who has been notified that he or she "needs improvement" in this area.

Database structure also provides visibility into the errors that have been found while performing the reconciliation process. You can run reports at any time to show what errors have been found so management can determine whether there's a material misstatement in the financial reports. Since many small errors can accumulate to a large amount, you also can see the aging of these errors to monitor the process of following up on a timely basis.

Not only has all this helped in improving the company's financial reporting and controlling the reconciliation process, but everything is documented electronically so it can be reviewed by the company's senior financial managers and the external auditors. The complete process is easily auditable to provide the ability for the auditors to attest to this as a key control.

As we've all heard many times, "What gets looked at gets done." Make sure your account reconciliation process goes through the correct scrutiny so the reconciliation will be done correctly and your reporting will be accurate.

Our 40th President, Ronald Reagan, also gave us some words of wisdom. He probably wasn't talking about account reconciliations, but this quote certainly is on target for a great reconciliation process: "Trust, but verify." **SF**

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