Balance Sheet Reconciliations

MEDIA REPORTS CONTINUE TO HIGHLIGHT the impact of complex instruments or tricky multilevel transactions regarding an organization’s financial health, while billions of dollars are tossed about by a combination of market forces and emerging valuation techniques. The resulting financial reporting challenges are significant and demand rational approaches as well as application of one of the oldest — yet most effective — accounting control processes: balance sheet account reconciliations.

Reconciliations have long been an important control for ensuring financial statement accuracy. Validating balances in general ledger accounts through the reconciliation process provides management with assurances that controls are in place and are working effectively.

Performing accurate and timely reconciliations has received considerable attention since the U.S. Sarbanes-Oxley Act of 2002 was enacted. Sarbanes-Oxley requires management to assess the internal control structure’s design and test its control effectiveness. The internal control structure often contains a network of overlapping, complimentary, and redundant controls, and identifying and choosing controls on which to rely requires professional judgment. However, because of their summary and comprehensive nature, reconciliations often become key, rather than secondary, controls. The significance of being labeled a key control is that management places greater reliance on the performance of its key controls — which are tested as part of Sarbanes-Oxley — to ensure the accuracy of its financial reports. Therefore, it is important for internal auditors to understand best practices related to account reconciliations and have a clear plan for reviewing them.

BEST PRACTICES
Numerous best practices can be helpful to internal auditors when auditing account reconciliations. Practical ideas for improving the effectiveness of an organization’s account reconciliation process include:

- Formalizing a policy for reconciling and reviewing all balance sheet accounts.
- Completing a risk assessment of all balance sheet and off-balance sheet accounts and determining risk level.
- Designating a regular cycle for the process (e.g., monthly reconciliations for high- and medium-based risks and quarterly for low-based risks).
- Completing account reconciliations by a specific calendar day of the subsequent month.
- Using a standard format for preparing reconciliations across the organization, and ensuring each reconciliation contains standard information.
- Assigning one preparer and one reviewer to each reconciliation to be performed.
- Confirming that the preparer and the reviewer possess the adequate skill sets to perform their functions, understand the nature of the account being reconciled, and understand the documentation and analysis required to support and substantiate the account balance.
- Considering automating the reconciliation process.

Although there are no guarantees, employing these practices can help reduce the risk of misstatements.

INTERNAL AUDIT’S ROLE
Internal audit should be responsible for independently assessing compliance with stated procedures. When performing...
audits of reconciliations, it is essential that auditors consider various attributes. Including the following testing procedures can help auditors perform a complete and adequate review.

1. **Does the “balance per the general ledger” on the reconciliation agree to the amount reported on the general ledger?** One common problem is not reconciling the full general ledger balance (e.g., to a subaccount, to only the cash or accrual or tax subledgers, or to only a subsidiary account).

2. **Does the “balance per bank” or “balance per system” agree with the bank or system report?** A recurring issue is reconciling the general ledger activity to the general ledger balance rather than to an outside source. Reconciling one general ledger source to another, such as a trial balance to an online balance report, will accomplish nothing — unless the intent is to test the general ledger system’s reports.

3. **Are there any unreconciled differences?** Unreconciled or unknown differences should set off alarm bells. These differences mean the reconciliation work has not successfully identified all reconciling items. This typically indicates that the individual preparing the reconciliation does not have the appropriate skills or did not devote the time necessary to complete the reconciliation.

4. **Are reconciling items being cleared timely?** Unless the reconciling items identified are purely timing issues, they should result in some action (e.g., a journal entry or an entry to correct a subledger). These actions should clear the item before the next reconciliation is performed, because if they are not cleared, it is an indication that the work is not being performed. As many organizations are operating with lean accounting departments, completing account reconciliations both correctly and timely can be a difficult task. However, staff shortages do not justify rolling reconciling items forward from period to period. Although this approach is quicker and may seem mundane and repetitive, a strong account reconciliation process is an important component of a solid system of internal controls. Implementing account reconciliation best practices — such as accountability, risk-based prioritization, and automation — provides management insight into the substance of transactions and account balance content.

5. **Was the reconciliation signed by the preparer and reviewer, and are the preparer and reviewer different individuals?** Having two signatures indicates a segregation of duties. The reviewer also should help ensure that reconciliations are consistent.

6. **Was the reconciliation completed on time?** Reconciliations should be completed before the data or report for the next reconciliation becomes available. Thus, a bank account reconciliation would be considered late if it was not completed before the following month’s bank statement was received.

7. **Has the organization established a monitoring control over reconciliations?** Reconciliations are such an important control that many organizations have implemented an organizationwide policy or centralized monitoring to ensure their timely completion. All balance sheet accounts should be reconciled.

**RECONCILIATION TYPES**

There are various types of reconciliation, and each has nuances that will indicate the nature, timing, and extent of audit tests. Some of the more common types include:

- **Basic account reconciliations.** Often far from basic or simple, these account reconciliations may be reconciled to an accounts receivable aging schedule, fixed asset ledger report, or an accounts payable report.

- **Bank account reconciliations.** This type of reconciliation is between a bank statement and a general ledger account. Zero balance accounts add a twist to the generic bank account reconciliation, because the bank account is swept or funded daily, leaving the end-of-day balance at zero. Completing the bank account reconciliation helps establish the accuracy of the balance in the general ledger by confirming the balance with the bank.

- **Suspense account reconciliations.** Suspense accounts are used as a “holding” account until the appropriate disposition or classification of the transaction can be made (e.g., a lockbox used for all deposits). Once the cash deposit is recorded, the organization will then determine why it was received and book the corresponding entry to clear suspense (e.g., to post it against a notes receivable or to book revenue). Testing procedures should be added or modified to address the specific nature

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**FINDING BALANCE**

Performing appropriate and timely reconciliations is a critical control function that should be in place in all organizations. Although account reconciliations may seem mundane and repetitive, a strong account reconciliation process is an important component of a solid system of internal controls. Implementing account reconciliation best practices — such as accountability, risk-based prioritization, and reconciliation automation — provides management with insight into the substance of transactions and account balance content. A robust reconciliation process can identify necessary adjusting entries before financial or other regulatory reports are issued, while also reducing restatement risk, improving investor confidence, and eliminating write-offs.

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