Cheque Kiting? I have an Idea!!

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Abstract

This article is about the cheque collection accounting treatment in US and its possible abuse for cheque kiting and misrepresentation of cash reported on the balance sheets. There has been cheque kiting incidents where fraudsters were able to pretend that they had money in their bank accounts. The present electronic cheque clearance has reduced this possibility of cheque kiting but did not erase it. Banks still credit customer account with deposited cheques and let their customers use some of that money. The article is proposing that cheque is an account receivable until it is collected and the banks should not credit customer accounts with the deposited cheques. Likewise companies-businesses should not debit their cash balances with cheques received from customers until the cheques are collected through the banking system.

Purpose – The paper explores the present cheque clearance system in US and its possible malpractices in the practical sense. Cheque kiting has been a way of creating fictitious cash balances on the balance sheet which is fraud. It can be protected by a different accounting treatment.

Design/methodology/approach – The paper compares the cheque clearance system in US with Author’s own experiences from Turkey. It purports the riskiness of present cheque clearance system on the financial statements and suggest a practical accounting application to prevent possible financial statement misrepresentations.

Findings – The paper explores that if the present accounting treatment is changed both for the banks and the businesses, the possibility of cheque kiting and misrepresentation of cash balances on the balance sheet will end. Basically cash is the amount that can be used by the customer, the rest is not cash, it is “cheques in collection” and it should be treated as an accounts receivable until it is collected.

Practical implications – Financial statements are vital for the business world. Based on these statements banks lend money, governments collect taxes, people buy and sell stocks. They need to be presented fairly. The present accounting application on cheque clearance is not transparent enough in US, it might lead to misrepresentation of financial statements. The paper suggests a practical solution to this problem. By changing the accounting treatment the companies will only show cash in their cash accounts not the cheques in collection process.

Social implications – Fair treatment is the motto for any situation we face in our daily lives. One might be a poor person or rich but the treatment should be fair unless s/he is a fraudster. A rich person’s cheque is deposited in his/her bank account the next business day and a poor person’s cheque might take days to be credited. This is not a fair treatment. The paper suggests that there has to be a one way accounting treatment regardless of the depositor’s financial situation.

Originality – This paper has been prepared on the Author’s past business experience in Turkey and his study of the US cheque clearance system and comparing the two. It reflects the real world examples of cheque kiting and its negative consequences in US and proposes a solution.

Key Words: Cheque kiting, misrepresentation of financial statements, fraud
1. Introduction

A few years ago, my niece lost a couple of thousand dollars due to cheque kiting fraud. She wanted to rent her apartment in Washington D.C. through an Internet site. The so called renter (!) sent her a couple of cheques covering a few months’ rent in advance. Within 24-hours of her depositing the check to her bank, her account showed the checks were credited. A few days later, the renter asked two thousand dollars from my niece for his/her urgent needs and said that “you were covered since you had my cheques.” My niece wired the money electronically to the renter’s account. A few days later the cheques given by the renter were dishonored and there was no way for my niece to recover the money. This is a true story, with many other similar cases that have taken place in the history of fraud.

The notorious car pet cleaner boy-Barry Minkow and his business called “ZZZZ Best” is another example of cheque kiting. He discovered that cheque kiting was a good method to keep his business bank accounts high. The following excerpt is from Wikipedia, https://en.wikipedia.org/wiki/Barry_Minkow#cite_note-CleanSweep-3: “At times, he (Barry Minkow) found it difficult even to meet payroll. Faced with a shortage of operating capital, he financed his business via check kiting, stealing and selling his grandmother's jewelry, staging break-ins at his offices, and running up fraudulent credit card charges.”

As an example, he would write cheques on his business name (as the payee) from one bank account to another, pretending that he had three bank accounts: A, B and C with nil account balance in all of them. He writes a cheque, for instance for $5,000 from his account with bank A and gives the cheque to his bank B. Bank B immediately credits his account. Then he writes another cheque from his account with bank B assumingly for another $5,000 and deposits it to bank C. Bank C immediately credits his account. So instantly his business has $10,000-free money in two bank accounts. I.e., on March 31 his business balance sheet would show $10,000 in his bank account which would also be confirmed by the bank statements on March 31. Bank B and C, after receiving the cheques, would send them to interbank clearance system for collection. This would take a few business days until each bank finds out that the cheques were dishonored and consequently would deduct the amounts from his bank accounts and return them to him with an NSF (Not Sufficient Funds) stamp on them. Cheques would become useless but have been sufficient enough to float his business for a few days. This period depends on how quickly the cheque is cleared through the interbank cheque clearance system. If the cheques were written from another state, it might even take longer to be cleared and the fraudster would be able to keep his accounts float a for few more days. There are other examples of cheque kiting.

BMO-Bank of Montreal filed its lawsuit last year, alleging that Mair Faibish of Long Island, N.Y., the former chief executive officer of a bankrupt food company called Synergy
Brands Inc., had participated with several Toronto-area business people in an international cheque-kiting ring. Mr. Faibish is also facing criminal charges in the United States, and was arrested in April. He has pleaded not guilty (Gray, 2012).

2. Discussion

In the first part of the discussion I will present the cheque accounting treatment from a bank’s point of view and then from the business customer’s point of view. This discussion is purely on receiving other banks’ cheque from a business owner or company point of view where they might receive cheques from their customers drawn on all banks in the country. A local business owner-company works with one or two banks in the location of the business. If the company receives only the cheques drawn on its own bank(s) then the procedure would be very easy, the company/business owner or an authorized person of the company would take the cheques to the company’s bank that they do business with and cash the cheque in minutes. But this represents a very unique situation and might be far from reality, because as a business owner you will never know what banks his/her customers are working with and the chances that you dictate your customer what banks to work with are very slim. The following has been taken from Federal Reserve Bank (FED) of New York’s website, https://www.newyorkfed.org/aboutthefed/fedpoint/fed03.html: In 2009, interbank checks, which are checks that are deposited at and drawn on different depository institutions, accounted for about 74 percent of the checks paid that year. The remaining 26 percent of checks were "on-us" checks, which are deposited at and drawn on the same depository institution.

The present cheque handling system in USA is allowing room for cheque kiting. If banks change the cheque accounting treatment, this fraudulancy would stop forever. Presently banks do the following accounting entries when they receive the other bank's cheque(s) from a deposit owner (the name of the accounts might differ from bank to bank):

Dr Bank cheque deposit account XXX
Cr Customer current-deposit account XXX

Then sends the cheque to interbank clearance system:

Dr. Interbank cheque clearance account XXX
Cr Bank cheque deposit account XXX

If the cheque is honored by the payee:

Dr. Cash XXX
Cr Interbank cheque clearance account XXX

At the end of the cheque clearance process bank debits its cash account.

If the cheque is dishonored by the payee:

Dr Customer current-deposit account XXX
As it is seen above, temporary accounts (interbank cheque clearance account and bank cheque deposit account) are closed and customer’s deposit account is either credited or debited depending upon the cheque is honored (the bank receives the cash) or dishonored (the bank does not receive the cash). This whole process might take a few days during which fraudulent people can show fictitious amounts of money on their bank accounts. This can be stopped. Simply by not crediting the cheque to customer’s deposit account until it clears the interbank cheque clearance system. I would like to propose the following entries when the bank receives other banks’ cheques from their customers:

\[
\begin{align*}
\text{Dr Bank cheque deposit account} & \quad XXX \\
\text{Cr Temporary cheque clearance account} & \quad XXX
\end{align*}
\]

The bank, after making the above entry would send the cheque(s) to interbank cheque clearance system and wait for the results. If the cheque is honored:

\[
\begin{align*}
\text{Dr Cash} & \quad XXX \\
\text{Cr Bank cheque deposit account} & \quad XXX
\end{align*}
\]

\[
\begin{align*}
\text{Dr Temporary cheque clearance account} & \quad XXX \\
\text{Cr Customer current-deposit account} & \quad XXX
\end{align*}
\]

If the cheque is dishonored:

\[
\begin{align*}
\text{Dr Temporary cheque clearance account} & \quad XXX \\
\text{Cr Bank cheque deposit account} & \quad XXX
\end{align*}
\]

The bank, would return the cheque to the customer with an NSF stamp on it and then customer could take the legal action against his/her customer. In the accounting entries presented above the cheque has not been credited to customer account in the first place by the bank and it is the essence of the discussion.

Accounting is the science of reflecting real economic events on the books of the company. For the banks, in the cheque clearance process, the usage of temporary accounts before crediting the customer’s deposit account could be the true reflection of the reality. In the above entries the bank’s cheque collection charges have been ignored to keep the entries simple. In reality there will be a charge for the business owner-customer for cheque clearance by the bank.

If we look at the picture from business owner-customer’s point of view, we see the following: Business owner sells the goods or render the services to his/her customers on credit, the accounting entry is (ignoring cost of goods sold entry):

\[
\begin{align*}
\text{Dr Accounts receivable} & \quad XXX \\
\text{Cr Sales} & \quad XXX
\end{align*}
\]

Then the customer send a cheque for payment, if the cheque is honored:
Dr Cash XXX
Cr Accounts receivable XXX

If the cheque is not honored:
Dr Accounts receivable XXX
Cash XXX

Then the business owner will either ask for cash or take another cheque from the customer or take a legal action against the customer. This procedure is entirely between the customer and the business owner and depends on their business relationship.

The above entries reflect what the business owners-companies do when they receive cheques and this is what accounting instructors teach in financial accounting courses at business schools. Is this a correct entry? The answer is no. This is not the correct entry. Because if the cheque belongs to another bank, other than the bank the business owner does business with then the business owner-company would wait for the clearing of the cheque. When the business owner receives a cheque from his/her customer the correct entry should be:

Dr Cheque clearing account XXX
Cr Accounts receivable XXX

When the cheque is cleared through the bank:
Dr Cash XXX
Cr Cheque clearing account XXX

From business point of view, as a business person you are receiving a cheque from the customer and either you do not know the customer or you might know the customer but the cheque(s) could be endorsed by your customer that you do know the payee. In either case the bank should not credit the business owner’s deposit account until the cheque(s) is (are) cleared through the interbank clearance system. In the examples given above, for the sake of simplicity it is assumed that there is one cheque in the clearance system, but assume that there are hundreds of cheques received each day by the business owner and each business day these cheques are passed onto the bank. The business owner will assume that he/she has enough money in his/her deposit account to make the payments and accordingly signs cheques for his/her suppliers for the periodical payments. The cheques will be cleared from his/her business account as his/her suppliers present these cheques either to the business owner’s bank or to their own bank for clearance.

Here there is a risk that the business owner’s account may turn to a debit balance if his/her customers do not pay all their cheques. Assuming that the business owner has an overdraft agreement with the bank then the business owner will be paying interest for the days that his/her account went on the debit side (overdrawn). This is not fair to the business owner.
Banks might say that “we credit your account with the cheques that you pass onto us for clearance” is a good statement for the customer purporting that the bank trusts the customer but it might have complications in practice and end up with the customer suffering at the end by paying interest.

The author has been a finance and accounting director in cement business many years ago while he was employed in Turkey. The practice was that 99.9% of the payments made by customers in cement and rolling mix concrete business would be made by cheques. Cheque was the mean of payment in that industry and there was a risk of non-payment at all times. You could not blame the customer for non-payment if the cheque was endorsed by the customer. However you could ask for action. If the customer is in good faith then he/she would either replace the dishonored cheque(s) with a new one(s) and considering the time value of money, the customer normally would pay an interest for not paying on time or would write his/her own cheque including the interest for the time lapsed between the original collection date and the new date of payment or pay cash. The cement selling part of the business was more secured because you would not sell directly to the end user from the cement plant. Instead you would sell the cement to your cement dealers with whom you have dealership agreements and have their letter of guarantees on which the cement factory was the beneficiary for the maximum amount (credit) that they could buy. But the rolling mix concrete industry was different. You did not have dealers and the customers would mostly pay by cheques. Besides the repeat customers, in many of the occasions you did not know the customer. Due to competition you could not restrict the credit conditions for the customers or ask them to present their own cheques otherwise they would buy it from the competitor(s). The number of cheques that the company would receive from the customers was around 450 on a daily basis. In order to follow this high number of customers and cheques the company had an “Accounts Receivable Department.” The number of customers, especially in the summer months-high season for construction would be around 4,000. The procedure for the follow up of this high number of cheques on a daily basis is that the bank(s) that the company worked with would install their computer screens in the “cash department” that would work closely with the “accounting receivable department” so that the management could follow the cheques on a daily basis and take action for the bounced ones immediately.

Another application that the author has experienced in the past in Turkey with the banks based on one business day clearing system was the following: Assume that today the company has received cheques (drawn on various banks in the country, the number of cheques is not important) for $1,000 in total. 80% of this amount would be in the deposit account that the company could use $800 the same day. There is a risk that some of that $1,000 could be bounced cheques. The next business day the company received another $1,000 of cheques, the company would use $200 (the balance of the previous business day) +

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$800 (80% of today’s cheques) = $1,000 usable amount of today. Assume that $100 of the previous day’s cheques were bounced then the usable amount of today would be $900. This was a fair and easy application that as a reputable company the management would not bother running the cheques individually for collection from each bank that the process would take the whole day of a company’s clerk running from one bank branch to another and still would be able to use the available amount the next day because the physical process would consume the whole business day. What the above anecdote tells us that if the company is using the money it is cash otherwise it is not cash.

3. Literature Review

Cheque clearing historically started in England in 1600s and developed and spread out to the rest of the World. In the old days different banks’ representatives including FED’s would meet in a room and exchange the cheques that have been deposited by the customers in their branches. For each bank a certain bank branch would be responsible for cheque clearance in each city. After the exchange, each bank would take its own cheques and deliver the those cheques that belonged to the other banks. In accordance with the amount of exchange, each bank would either pay to or receive money from other banks within the FED system. In 1990s we have seen the development of electronic clearance with the machine-readable numbers on the cheque.

The following paragraph has been taken from Bank for International Settlements` website https://www.bis.org/cpmi/paysys/unitedstatescomp.pdf: ...”1.1.1 Cheques: Articles 3 and 4 of the UCC-Uniform Commercial Code together form the legal basis of paper-based cheque transactions in the United States. In addition, Congress passed the Expedited Funds Availability Act of 1987 (EFAA), which granted the Federal Reserve Board authority to make improvements in the cheque collection and return system in the United States. In accordance with the EFAA, the Federal Reserve issued Regulation CC, which includes a number of provisions designed to improve and accelerate the collection and return of cheques among deposit-taking institutions. In addition to Regulation CC, cheques collected through the Federal Reserve are governed by subpart A of the Federal Reserve’s Regulation J, which provides rules for collecting and returning items through the Federal Reserve.”

As checks are received at various bank locations, they are encoded and then transported to a central processing site where they are sorted according to the destination bank/s using high-speed reader/sorter machines. Given the sheer volume of checks to be processed (which can be more than one million checks per day for a medium size regional bank), the checks undergo multiple passes through sorting machines until such a time that all checks are sorted to the finest desired level. The sorted, bundled checks are then cleared through the banking system for collection of funds from the paying banks on whom the checks are drawn.
Alternate clearing routes—through Federal Reserve banks, correspondent banks, or direct sends—are available for this purpose. The high volume of checks, the large number of destination banks, the availability of multiple routes with different cost structures, and the limited time windows within which deposited checks must be sorted and sent out for clearing, all combine to make operational planning for check sorting and clearing a very challenging task indeed (Apte, Ahn, Guignard-Spielberg, 2011).

The Check Clearing for the 21st Century Act allows banks to exchange check images electronically. The act was created in response to Sept. 11, 2001, when the system of transferring checks essentially shut down. The Check 21 act doesn't mandate image exchanges; it only requires banks to be able to accept the legal equivalent of checks: copies of original checks called "substitute checks" (Saranow, 2004).

The following excerpt has been taken from FED of New York, https://www.newyorkfed.org/aboutthefed/fedpoint/fed03.html: Today, the Federal Reserve receives almost all the checks it processes for clearing as electronic check images. Regardless of whether checks are processed as paper or electronic items, financial institutions have several alternative ways to receive payment for, or clear, checks deposited with them. And according to FED’s Payment Study of 2016 - https://www.federalreserve.gov/newsevents/press/other/2016-payments-study-20161222.pdf:
The number of check payments fell to 17.3 billion with a value of $26.83 trillion, down 2.5 billion or $0.38 trillion since 2012.

The following excerpt has been taken from Theresa Kim’s article on March 27, 2017 on (https://www.mybanktracker.com/news/long-takes-check-clear-top-10-banks): “After making your deposit at an ATM or inside the branch, you will receive a deposit receipt with the date and time of when the check will be cleared and the hold time on the check, if any. (A hold time refers to how long the check will be placed on hold, and banks use many factors to determine this, including your account history and account balances.) The actual time of how long it will take for the check to clear won’t stray too far from the expected time presented on the deposit receipt. You can expect the funds to be available as indicated on the slip, which is usually a one to two business days, at most, unless it is a large amount. Large deposits: The policy for very large deposits by bank. We recently spoke with a banking representative at Chase Bank, who better explained their policy to us. The rep explained that the speed of the check deposit also weighs heavily on the banking relationship the customer has with Chase. Let’s say Chase customer John Doe is in good standing with the bank and normally keeps a high balance in his account and wants to deposit a $10,000 check. The rep told us in this case, the check would probably clear the next business day. However, if John normally had an average balance of $1 in his account and tried to deposit $10,000, Chase would probably put the check on hold (for up to 10 business days). In addition, if John showed regular overdraft
activity and had a number of returned deposits, it would also delay the clearing of his check.”

According to the same article: “Most banks will generally provide the depositor with at least $200 for immediate availability after a check deposit is made. Also, when you’re using your online banking to your funds, you may see two different figures listed for “account balance” and “available balance.” The available balance indicates the amount you have to use at your disposal and the account balance shows the total amount you have in your account — including money that has yet to clear.”

If all banks can make this distinction of available balance and account balance on their statements, the bank side of the problem will be solved. Fraudsters can not claim that he/she has so much money in the bank(s) vis a vis their auditors because what he/she can use is only the available balance and those cheques that have been deposited for cheque kiting will only increase the account balance not the available balance.

With the visible prospect of same-day presentation and settlement of cheques nationwide in the US, the country has come a long way in reducing both bank and corporate risk in a very short time. It was not many years ago that cheques drawn on remote locations in the US took several weeks to clear. Some countries, such as Italy, which has recently reduced the official clearing time for cheques to nine days, still have a long way to go (de Caux, 1993).

As it is understood from the literature review, the cheque clearing system in US performed under FED scrutiny and supported by Cheque 21 Act and other acts and FED regulations. Even though there are other alternative payment methods (electronic fund transfers, credit cards, debit cards etc.) other than paying by cheques and cheque payment has been on decline, it is still around 17 billion in number and worth of $26.83 trillion in value which makes up the 15% of the total non-cash payment in US (total non-cash payments in US in 2016 is $177.85 trillion, calculated from the figures given on FED’s Payment Study of 2016).

4. Conclusion

This article is not critising the business relationship between banks and their customers, it is only critising the cheque accounting treatment and its negative consequences on the balance sheet and the possibility of cheque kiting related with this accounting treatment.

Even at the most developed phase of electronic clearance systems of today, cheque kiting is still a possibility eventhough the amount is $200 per deposit in average per bank. Besides the fraudster by writing fictitious cheques can still claim that he/she has so many dollars in the bank account(s) while in fact there is non. Cheque kiting is also misrepresentation of financial statements which is also a fraud.

There is a difference in treatments of customers in the banks. Those who have high balance in their chequeing accounts are treated highly, and any cheque deposited by such customers are made available to them the next business day. On the other hand a poor
customer with $1 average chequing account balance should wait up to ten business days or even more. This is not a fair treatment, people should not wait longer because they are poor. Of course it is up to the bank and the customer. If customer is not happy he/she can change the bank.

If the accounting treatment is changed both for the banks and the businesses, the possibility of cheque kiting and misrepresentation of cash balances will end. Cash is the amount that can be used by the customer, the rest is not cash, it is “cheques in collection” and it should be treated as an accounts receivable until it is collected.

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