

Share Draft Accounts

The Federal Reserve Bank estimates that more than 12 billion checks were written in 2005.

While many of us use debit or credit cards, share drafts (or checks) are a primary method for moving funds from one person or organization to another. The Federal Reserve Bank estimates that more than 12 billion checks were written in 2005. Share drafts will continue to be an important part of our financial systems for the coming years.

What Is a Share Draft?

A share draft is a negotiable instrument. A **negotiable instrument** is a promise or order to pay a fixed amount of money. A negotiable instrument must be:

- An unconditional promise/order that does not require any other act;
- Payable to “bearer” or a named person or organization;
- Payable on demand or at a definite time;
- For a fixed amount of money;
- Signed by the issuer or maker; and
- In writing.

Most share drafts have at least one perforated edge. The required elements of a share draft are the:

1. Maker’s signature;
2. Bearer’s name;
3. Numeric amount of the share draft;
4. Written amount of the share draft;
5. Serial number;
6. Account number;
7. Routing number;
8. Name and address of financial

Objectives

Upon completion of this chapter, you will be able to:

1. Identify key elements of a share draft;
2. Explain the steps in the share draft cycle;
3. Cite the general ledger accounts affected by the share draft posting process;
4. Identify types of adjustments needed to reconcile share draft accounts; and
5. Reconcile the cash letter to the total posted in the deposit-in-transit account.

institution on which the share draft is drawn;

9. MICR line; and
10. Date.

Share Draft Cycle

Now that you understand what makes a share draft valid, let’s look at the process of issuing a share draft.

1. Jenny Jones, a member of American Federal Credit Union, writes a share draft payable to her friend Maggie Smith for \$100. In this case, American Federal Credit Union is the **paying bank**, and Jenny Jones is the maker.
2. Maggie Smith, the named party, or bearer, deposits the share draft into her account at National Federal Credit Union. Nation-

- al Federal Credit Union, in this example is the **depositing bank**, or **bank of first deposit (BOFD)**.
3. The National Federal Credit Union (the bank of first deposit) prepares a cash letter. A **cash letter** is one or more bundles of share drafts deposited within a given period (usually one day), up to 300 per bundle. The cash letter is sent to a clearinghouse.
 4. At the clearinghouse, the share drafts are sorted and settled, then sent to the individual credit unions. The clearinghouse deposits \$100 to the National Federal Credit Union account and withdraws \$100 from American Federal Credit Union (the paying bank).
 5. The original share draft (or an electronic copy of it) goes back to the American Federal Credit Union account and clears Jenny Jones' account. Payment has been made to Maggie Smith. The share draft processing system is

evolving from manual handling at all points to automation at all points. A member may not even have to write the check—it may be “written” by a machine at the grocery store, for instance—and sent electronically through the clearing process.

Complete activity 2.1 to be sure you understand this process.

Paying Bank Cycle

When the credit union pays out share drafts, it's a paying bank. When the credit union accepts share drafts and checks, it's the bank of first deposit. When we refer to credit unions or banks, they're financial institutions (FIs).

Let's look at how paying banks handle share drafts. First, we start with the paying bank; that is, we start with a member writing a share draft and the paying bank receiving electronic data from a clearinghouse. We go through the process of how the paying bank “journalizes” or accounts for the funds coming from members' accounts into the bank's

Activity 2.1

Share Draft Processing Scenario



Read the scenario below and then label the person or institution with the role that they play.

Jeff Smith, a member of the Farmer's Credit Union, writes a share draft to Sarah Wagner for \$200. Sarah is a member of the Teacher's Credit Union.



Jeff Smith



Sarah Wagner



Teacher's Credit Union



Farmer's Credit Union

Paying Bank

Bearer

Depositing Bank

Maker

Answers appear in appendix A.

electronic account books. Here is the paying bank cycle when member Devon Thomas writes a share draft.

1. Devon writes a \$1,000 share draft on the paying bank.
2. The credit union (as the paying bank) processes the draft.
3. The credit union pays out the funds through a clearinghouse.
4. The process begins with the daily balancing of the share draft file received from the clearinghouse.
5. The clearinghouse receives the information from the depositing bank.
6. The clearinghouse electronically transmits a **presentment file** to the paying bank.
7. The paying bank takes the \$1,000 sent to the vendor and posts it in the general ledger.
8. The paying bank then debits the share draft clearing account for \$1,000 and credits the cash account for the same amount. The share draft clearing account is a temporary holding account. It holds the gross amount from the vendor until all share drafts have cleared.

For the paying bank, the general ledger posting looks like this:

Dr Share draft clearing account	\$1,000
Cr Cash account	\$1,000

Remember, the share draft clearing account is a temporary holding account. It holds the gross amount from the vendor until all share drafts have cleared from individual member

accounts, such as the account for Devon Thomas.

In a new example, the next general ledger entry shows how much was withdrawn from member accounts. Remember, there are probably some nonsufficient funds and closed accounts, so not all the share drafts will clear. In this example, \$800 is available to pay out, so you would debit share draft accounts \$800 and credit cash accounts the same.

Dr Members' share draft accounts	\$800
Cr Cash account	\$800

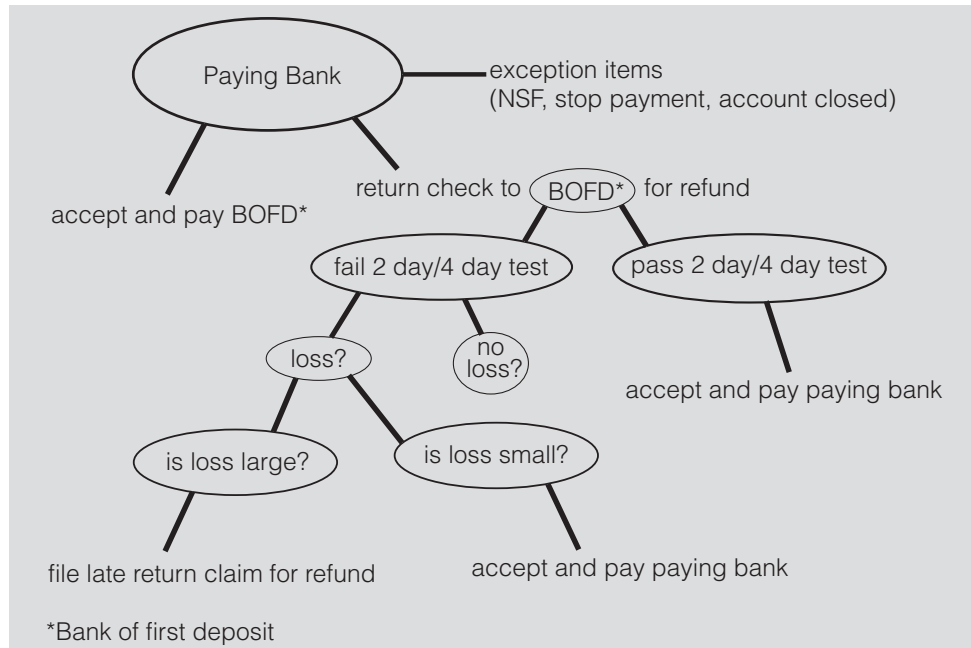
\$1,000 was presented and \$800 cleared. The remaining \$200 rejects as exception items. The credit union must decide which checks to pay and which to return, and some banks make this decision based on a decision tree like the one represented in figure 2.1.

In this example, the credit union decides to pay \$150. The general ledger entry for paid share drafts debits the member's share draft accounts, and credits the share draft clearing account.

Dr Members' share draft accounts	\$150
Cr Share draft clearing account	\$150

The credit union doesn't pay the remaining \$50. The data processing system makes an entry to zero out the share draft clearing account, and moves the balance to share draft returns account.

Figure 2.1
Payment Cycle Decision Tree



Dr Members' share draft returns account	\$50
Cr Share draft clearing account	\$50

Now the cash account activity needs balancing. The cash account shows a credit of \$1,000. You would verify that the cash account posting matches the vendor's confirmation report and correct payment to the banks of first deposit. Check for a debit entry of \$1,000.

Cash Account			
Date	Description	Debit (\$)	Credit (\$)
15 May	Share draft file		1,000

FI Account			
Date	Description	Debit (\$)	Credit (\$)
15 May	Item processing	1,000	

The debit balance in the share draft return account is \$50. A credit of \$50 will post to the corporate account when the banks of first deposit refund

the returned share drafts. Then a manual entry is made between cash and share draft return accounts to debit cash and credit share draft returns.

Dr Cash	\$50
Cr Share draft returns	\$50

To summarize:

- \$1,000 was the amount shown on the presentment file.
- \$800 cleared immediately; \$150 was questionable but ultimately paid.
- \$50 was returned unpaid.

The cash and FI accounts are shown here:

Cash Account			
Date	Description	Debit (\$)	Credit (\$)
15-May	Share drafts file		1,000
17-May	Returned drafts	50	

FI Account

Date	Description	Debit (\$)	Credit (\$)
15-May	Item processing	1,000	
16-May	Returned drafts		50

Errors and Claims

As you know, we use technology for almost all of our bank processes. However, the technology that encodes, sorts, reads, and moves funds between depository institutions is not 100 percent error-free. One type of error is the **encoding error**, or clearing difference. That’s when a share draft clears for an incorrect dollar amount. The error is usually found when the member reconciles the checkbook. For example, Nicole uses the online banking system at her local credit union. On Wednesday, she notices that her account is lower than she had expected it to be. A share draft for \$500 has been cashed. When Nicole clicks on the image of the share draft, she

sees that it was originally written for \$50. Nicole calls her credit union immediately to report the error.

To verify an encoding error, review a copy of the cleared draft and compare it to the amount posted to the member’s account. The variance is either a paying bank expense, or refunded by the bank of first deposit. To fix the encoding error, an adjustment request form is sent to the vendor handling the adjustment. For an example of this form, see figure 2.2. The Federal Reserve Board has determined that it is not cost effective for it or other vendors to process adjustments of \$25 or less.

Let’s look at how an adjustment of less than \$25 would work. Suppose a draft was written for \$65, but was encoded for \$80. The variance of \$15 is posted as a credit union expense.

The entry is:

Activity 2.2

Cash Accounts



Fill in the blanks with the correct amounts based on the following scenario.

- \$2,200 was the amount shown on the presentment file.
- \$1,200 cleared immediately; \$800 was questionable but ultimately paid.

The cash and FI accounts are show here:

Cash Account

Date	Description	Debit (\$)	Credit (\$)
15-May	Share drafts file	_____	_____
17-May	Returned drafts	_____	_____

FI Account

Date	Description	Debit (\$)	Credit (\$)
15-May	Item processing	_____	_____
16-May	Returned drafts	_____	_____

Answers appear in appendix A.

Dr Share draft expense account	\$15
Cr Member's share draft account	\$15

Encoding errors of more than \$25 are posted to a **suspense account** until payment is received from the bank of first deposit. Now suppose a share draft written for \$200 was encoded for \$300. The following entry is made for the \$100 variance.

Dr Share draft adjustment suspense account	\$100
Cr Member's share draft account	\$100

When payment is received from the bank of first deposit, the amount is credited to the corporate account. The following entry is made:

Dr Cash account	\$100
Cr Share draft adjustment suspense account	\$100

Another share draft error can occur between members' accounts. The adjustment can be corrected internally. The cause could be an incorrect reading of the MICR line. Sometimes when checks are folded, some of the magnetic ink rubs off. For example, an 8 can be read as a 3 when run through the clearinghouse sort equipment. This can cause a check to be posted against the wrong member's account.

To verify the error, review a copy of the cleared draft. Compare the name on the check to the name on the account the check cleared through. Rather than debiting one member's

account and crediting the other member's account, you should post two separate transactions to correct the error.

For example:

Member No. 1234, Williams, Check 8888 cleared for \$100. Williams claims it's not his check.

Dr Suspense account	\$100
Cr Member No. 1234 Williams	\$100

Purpose: To reverse Share Draft 8888 and return \$100 to Account No. 1234.

A review of the cleared share draft shows that the correct account number is 1284, Thompson.

Dr Member No. 1284, Thompson	\$100
Cr Suspense account	\$100

Purpose: To charge \$100 to Account No. 1284 and clear suspense account.

A **late return** occurs when the paying bank doesn't return a draft to the bank of first deposit within the time-frame outlined in Regulation CC. Reg. CC says that drafts must be returned within either:

- Two business days if both the bank of first deposit and the paying bank are in the same check processing region; or
- Four business days if the institutions are in different processing regions.

A deposit is received Monday at American Federal Credit Union, the bank of first deposit. That item is included in the cash letter prepared on Monday evening by the credit union.

The draft is sent with the cash letter

and received at the paying bank, National Federal Credit Union, on Tuesday. Tuesday is the day of presentment. The paying bank must notify the bank of first deposit by Thursday (two business days) that it's returning a draft. Why would a bank of first deposit (the depository bank) file a late return claim? This would be done because the bank would otherwise be accepting a loss. The loss has to be big enough to do the extensive research necessary in completing the claim.

For example: Smith deposits a check for \$5,000 from Jones on Monday. Smith doesn't know that Jones only has \$30 in the account. On Friday, the depository bank receives the returned check. Since the banks are in the same processing region, the paying bank has failed the two-day test.

Five thousand dollars is a large enough loss to spend time to research and process a late return claim. (If the amount was \$50, the credit union may accept the returned check and the loss would be passed on to the member). When a claim is filed, you would debit late return pending and credit returned drafts. The late return pending account will carry the balance until the claim is resolved.

Dr Late return pending account	\$5,000
Cr Return drafts account	\$5,000

However, if the depository bank accepts the loss, debit the share draft expense or the member's account, and credit the returned drafts.

Dr Share draft expense account	\$50
Cr Return drafts account	\$50

Now check your knowledge by completing activity 2.3.

Bank of First Deposit

Occasionally, drafts payable through another bank will be included in your credit union's share draft presentment file. These items are returned through the exception review process. The amount is part of the returned draft processing. Now the credit union will be the bank of first deposit. The bank of first deposit always prepares the cash letter.

When you receive a cash letter, stamp the back of each draft with the routing number and name of your credit union. This identifies the credit union as the bank of first deposit. Once all these drafts and checks are listed on the cash letter, the letter is sent to a clearinghouse.

Let's look at an example. Let's say that one Tuesday in August, members deposit drafts into the bank of first deposit amounting to \$100,150. Those deposits are posted to the deposit in transit account and members' accounts. The deposit in transit account is a cash account for the purpose of recording draft deposit activity. Separating this activity from the cash account makes reconciling more efficient.

The daily check deposit activity would look like this:

Dr Deposit in transit account	\$100,150
Cr Members' accounts	\$100,150

Activity 2.3**Share Draft Errors**

Select the correct answer from the choices below.

1. When a share draft clears for an incorrect dollar amount, this is called a
 - a. clearing difference.
 - b. encoding error.
 - c. share draft error.
 - d. both a and b

2. If there is an incorrect reading of the MICR line, this will likely result in a
 - a. clearing difference.
 - b. late fee.
 - c. share draft error.
 - d. late return.

3. Regulation CC states that
 - a. drafts must be returned within 10 days.
 - b. drafts must be returned within two business days if both the bank of first deposit and the paying bank are in the same processing region.*
 - c. drafts must be returned within five days if the institutions are in different processing regions.
 - d. drafts must be returned within 24 hours.

4. A late return occurs when
 - a. a paying bank doesn't return a draft to the bank of first deposit within the timeframe allowed by Regulation CC.
 - b. members pay their bills late.
 - c. an adjustment request form has to be sent.
 - d. none of the above

Answers appear in appendix A.

The next day, the cash letter is reconciled to the balance posted to the deposit-in-transit account. The reconciling procedure for the cash letter is:

- 1.** General ledger account amount (a): Equals all drafts deposited on a specific day; in this example, Tuesday.
- 2.** Add checks held from the previous day (b): Checks deposited on Monday but held and included in Tuesday's cash letter.
- 3.** Minus the value of checks held from Tuesday (c): Checks deposited to the deposit in tran-

sit account but not included in the cash letter.

- 4.** The general ledger adjusted total (d) = (a + b) – c.
- 5.** Cash letter sent total (e): Amount received from the proof operator.
- 6.** Difference = d – e.

For example, your calculated amount is traced to the corporate statement for verification. The entry made for May 22 would be for \$1,830,065. The spreadsheet shows multiple cash letters making up the \$1,830,065.

Dr Cash account	\$1,830,065
Cr Deposit in transit account	\$1,830,065

Payment for a cash letter is generally spread over three to four days. The amount you receive is based on the check processing location of the paying depository institution. The further away, the longer you wait for payment, within the two-day/four-day rule. A worksheet is created to trace when to expect payment of the entire cash letter.

Try your hand at balancing the general ledger by completing activity 2.4

Summary

In this chapter, you identified the key elements of a share draft and examined how a share draft works its way through the cycle. You also looked at the general ledger accounts and how they are affected by the share draft posting process. You identified the

types of adjustments needed to reconcile share draft accounts. Finally, you reconciled the cash letter to the total posted in the deposit in transit account.

You learned that a share draft is a negotiable instrument and that it must include certain elements such as the maker’s signature, the bearer’s name, the numeric and written amounts of the share draft, the serial number, the name and address of the financial institution, and the MICR line. You also followed a share draft through the bill payment cycle and examined how it is used to transfer funds.

The steps in the share draft process, like all credit union processes, are recorded. You assessed how the general ledger accounts are affected by the share draft process. You looked at what happens with returned drafts and how those are handled. Sometimes, you’ll need to make adjustments to reconcile

Activity 2.4

Balancing a General Ledger



Fill out the following table based on this scenario:

Your credit union took in \$500,000 of checks on Dec. 10. A cash letter was processed at the end of the day for a total of \$510,000. Included in the cash letter were checks from Dec. 6 for Operator 102 whose checks totaled \$100,000. Operators 221 and 445 left checks from Dec. 10 on their desks. Their checks totaled \$50,000 and \$40,000 respectively.

Apply the procedure learned in this chapter to balance the deposit in transit general ledger for the daily activity of Dec. 10.

General ledger amount: _____

Checks held from previous day: _____

Checks held from current day: _____

GL adjusted total: _____

Cash letter total: _____

Difference: _____

Answers appear in appendix A.

share draft accounts and you identified the types of adjustments involved and how to make them.

Finally, you looked at a cash letter, how it is used, and how to reconcile it to the general ledger. Scenarios includ-

ing the general ledger account amount, held checks, and the cash letter were analyzed and you saw how to complete and record all of these amounts. You also reconciled the cash letter to the general ledger.

PLAY PAGE



Test your understanding of the five steps of the share draft cycle.

Reminder:

To access the Play Page, go to <http://training.cuna.org/playpage/index.html>

or go to www.cuna.org and type “Play Page” into the Search Box.

Select the title of this module, and then the chapter you want to review.

