How to Perform a Cash Reconciliation

The Ultimate Guide for Accountants

Leapfin

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Chapter 1:

What is Order to Cash?

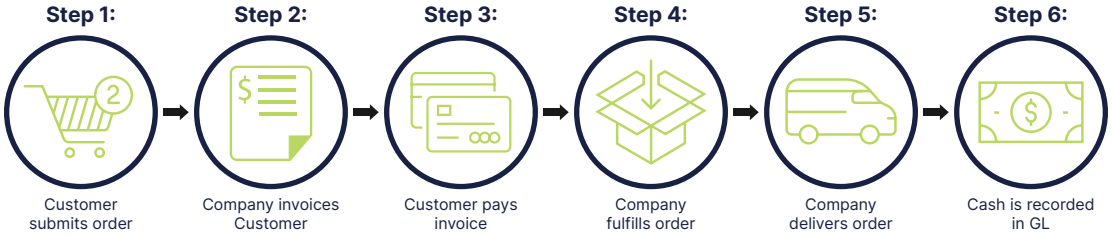
Order to Cash describes the procedure for processing customer orders, applying payments to invoices, and matching payments to the cash received in a company's bank account.

In this process, cash flows through a number of systems described in detail below.

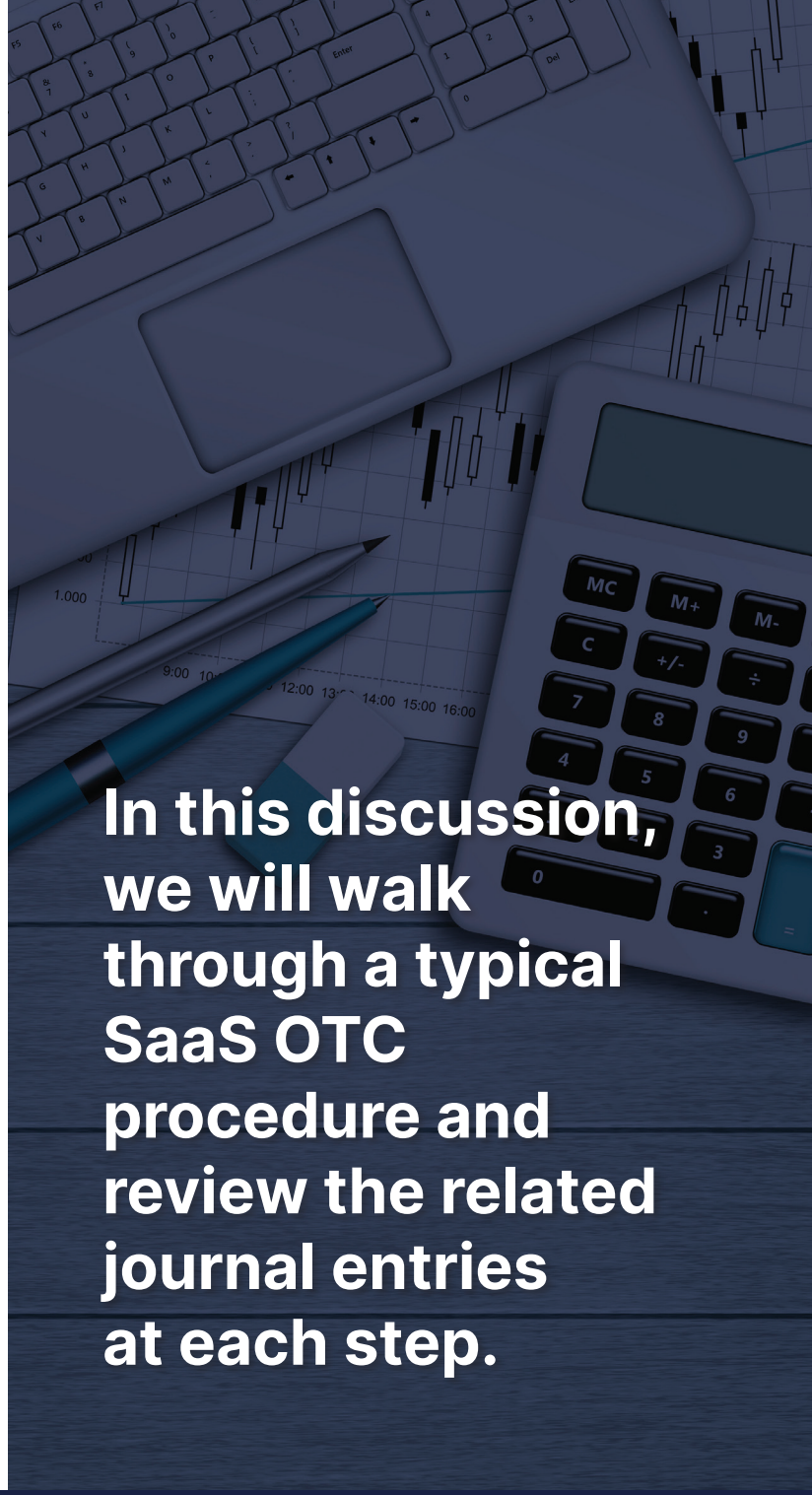
Accountants perform cash reconciliations to ensure that cash has appropriately gone through these systems for each transaction.

Before diving into the details of a cash reconciliation, it is important to understand the order to cash process and why it is important to accounting.

Order to Cash Process: A Step-By-Step Guide for Accountants



At a high level, Order to Cash (AKA OTC or O2C) describes the procedure for processing customer orders, applying payments to invoices, and matching payments to the cash received in a company's bank account. The principles behind OTC are essentially the same across all businesses and industries. However, the mechanics and ordering of OTC procedures do vary slightly for subscription and Software-as-a-Service (SaaS) business models.



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Let’s take a closer look

at each OTC step for a SaaS business

Step 1: Customer submits order

The OTC process begins when a company receives an order. For many SaaS companies with high transaction volume, orders are made directly on the company's website and immediately processed by a billing or order management system.

General Ledger Impact: No impact.

Step 2: Company invoices Customer

General Ledger Impact: No impact.

Step 3: Customer pays invoice

The order in which Steps 2 and 3 occur in the OTC process varies by company and operating model.

For high-volume SaaS companies where orders are placed directly through the company's website, customers are typically required to submit payment digitally before the order can be successfully processed (e.g. A subscription purchase for Spotify). Once payment information is provided, the customer can complete checkout, submit the order for fulfillment, and receive an invoice for the purchase. Invoices should include order details as well as any discounts or taxes, where applicable.

General Ledger Impact:

Month	Account	DR	CR
Jan 1	Accounts Receivable*	$500	
	Deferred Revenue		$500

*We will debit Accounts Receivable on the Balance Sheet instead of Cash, as credit card transactions may take up to 3 days to successfully process.

Note: In traditional non-SaaS or enterprise business models, order fulfillment and delivery may occur prior to invoicing.

EXAMPLE

On Jan 1, Customer browses Widget Company's online store and decides to purchase a one-year subscription for access to Widget's photo editing software for $500 (SaaS).

EXAMPLE (CONT.)

The annual fee of $500 for the one-year subscription is collected upfront by Widget Company. At checkout, Customer submits payment via credit card and submits the order. Next, Customer receives an invoice copy via email.

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Step 4: Company fulfills order

General Ledger Impact: No impact.

Step 5: Company delivers order

After receiving payment and invoicing the Customer, the Company must fulfill and deliver the order. For most SaaS companies, fulfillment and delivery occur simultaneously, simply by provisioning access to the software.

General Ledger Impact: No impact.

Step 6: Cash payment is recorded in General Ledger

The final step of the OTC process is to record the cash payment in the General Ledger and relieve the Accounts Receivable balance that was initially created upon invoicing in Step 2.

General Ledger Impact:

Month	Account	DR	CR
Jan 3	Cash	$500	
	Accounts Receivable		$500

Note: Having a cash reconciliation process in place will allow companies to match sales to cash received. This can provide Accounting teams additional assurance that revenue and deferred revenue are properly recorded in the General Ledger.

Optimizing the Order to Cash process should be a priority for every company. Streamlining OTC procedures improves margins and enables businesses with high order volume to scale efficiently. At each step, automation is key to creating an effective OTC process. With that accomplished, opportunities abound to automate closely-related processes such as Revenue Recognition and Cash Reconciliations.

EXAMPLE (CONT.)

On Jan 1, Widget Company received the completed order and provisions software access to Customer. The customer now has access to Widget's photo editing software for one year.

EXAMPLE (CONT.)

On Jan 3, the credit card payment is successfully processed, and Widget Company receives cash in the bank. The Accounts Receivable balance can now be relieved against the cash received.

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Chapter 2:

Introduction to Cash Reconciliation

A cash reconciliation is the process of verifying the completeness of a sale or transaction across the company's financial systems. Its completion provides assurance for both cash and revenue balances.

Multiple financial systems are involved in a cash reconciliation and generally, cash balances across these systems do not match.

The goal of a cash reconciliation is to account for all differences between these financial systems.

Cash Reconciliation vs. Bank Reconciliation

Cash reconciliations are often misunderstood to be the same thing as bank reconciliations.

A bank reconciliation

> is the process of matching transaction amounts reported in a bank statement with those recorded in the general ledger. Its purpose is to ensure that the cash balance recorded in the general ledger aligns with the entity's actual cash balance in the company's bank account. While companies and banks record the same transactions, the time at which a company records cash in the general ledger often differs from the time at which their bank reports the associated change.

A cash reconciliation

> is more complex and comprehensive than a bank reconciliation because it involves a company's entire financial technology stack. A cash reconciliation is the process of verifying the completeness of a sale or transaction across the company's financial systems. Its purpose is to account for all differences between these financial systems.

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EXAMPLE

Various systems involved in a cash reconciliation

Financial System	Examples
Billing System	Aria Chargebee Recurly
Payment Processors	Stripe Adyen Braintree/PayPal WorldPay
Revenue Recognition System	Leapfin NetSuite ARM Zuora RevPro
Bank	Bank of America JP Morgan Chase Wells Fargo

Note: Generally, the cash balances across these systems ***do not match***, which is precisely why accounting teams need to perform cash reconciliations.

Systems Involved in a Cash Reconciliation

A cash reconciliation can be complex because it involves a company's entire financial technology stack. Below are the four most common systems involved in a cash reconciliation. They can vary depending on company size, business model, or technological maturity.

Billing System:
A billing system creates and manages customer invoices that allow customers to pay for their purchases. Cash from billing systems represents how much cash is expected to be collected from sales.

Payment Processor:
A payment processor relays customers' payment information to a company's bank and the customers' banks in order to complete a transaction. It verifies payment legitimacy and provides instructions to banks for fund transfers. Cash from payment processors represents the final cash received by the company's bank.

Company's Bank:
A company's bank collects and deposits the cash from transactions that are successfully processed by payment processors. It is the final system involved in a cash reconciliation.

Revenue Recognition System:
A revenue recognition system calculates revenue for the current period and liabilities for future deferred revenues. It ingests information from both billing systems and payment processors to perform these calculations according to the company's arrangements and policies.

Common reasons for mismatch across these financial systems include:

- **Currency differences**
  Transaction currency, local exchange currency, payout currency
- **Foreign exchange translations**
  How an international company translates foreign subsidiary earnings into its reporting currency
- **Timing differences**
  Deposits in transit, time zones, etc.

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A Cash Reconciliation Example

Below is an example of what a cash reconciliation would look like after it is completed.
A cash reconciliation needs to aggregate cash balances from the main financial systems and identify the reconciling items across these systems.

In an ideal scenario, irreconcilable differences should total down to $0.

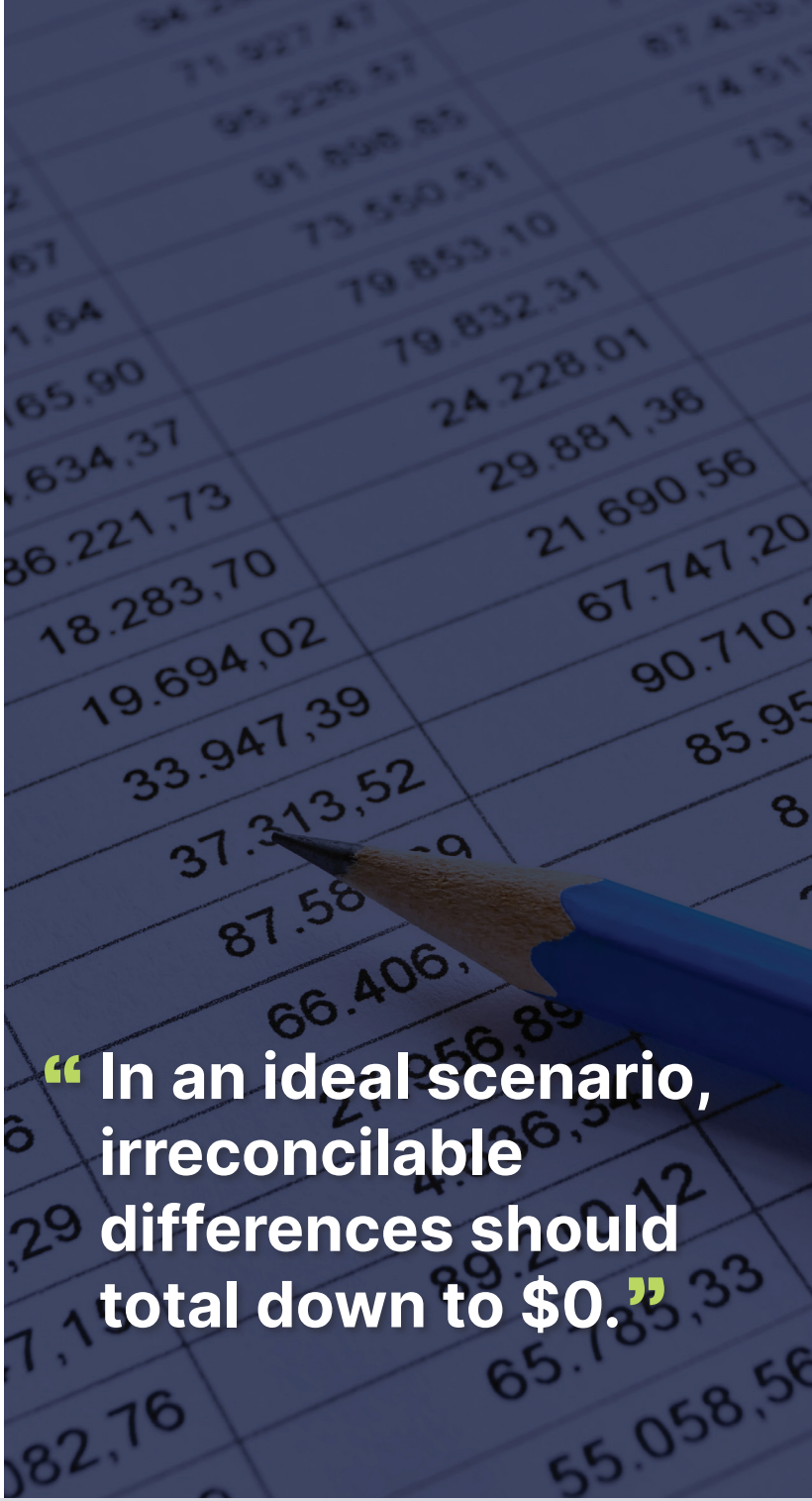
Sample cash reconciliation with reconciling items due to timing differences.

Reporting Period: March 1-31

Cash from Billing System	$500,000
Cash from Rev Rec System	$500,000
Cash from Payment Processor	$520,000 (a)
Cash from Bank	$510,000 (b)

Reconciling Items:

(a) Cash processed in March from February Sales	-$20,000
(b) Cash in transit from Payment Processor to Bank	-$10,000



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Chapter 3:

Why Accounting Teams Need Cash Reconciliations

First and foremost, cash reconciliations ensure that cash and revenue balances are reported accurately. By its nature, this assurance has several additional implications, listed to the right.

1. **Verification that operations are functioning properly and the company is collecting on all sales.**
2. **Prevention of revenue leakage.**
3. **Provision of trustworthy cash balances and revenue calculations for investors and stakeholders.**
4. **Testing and assurance of data integrity across a company's financial system, especially the revenue recognition system.**

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Problems That Arise Without Cash Reconciliations

Without cash reconciliations, businesses will find their financial reports inconsistent and unreliable.

For instance, cash can be inconsistently reported across financial systems (e.g.: billing system vs. revenue recognition system). In this case, misstated cash in the revenue recognition system can lead to misstated revenue.

In another scenario, Accounting, FP&A, Tax, and Business teams may all report different cash numbers. When there is no single financial source of truth for the company, inconsistent cash reporting is a common issue. Some major consequences of such include management making decisions based on erroneous data and over/underpayment of the company's tax obligation.

Chapter 4:

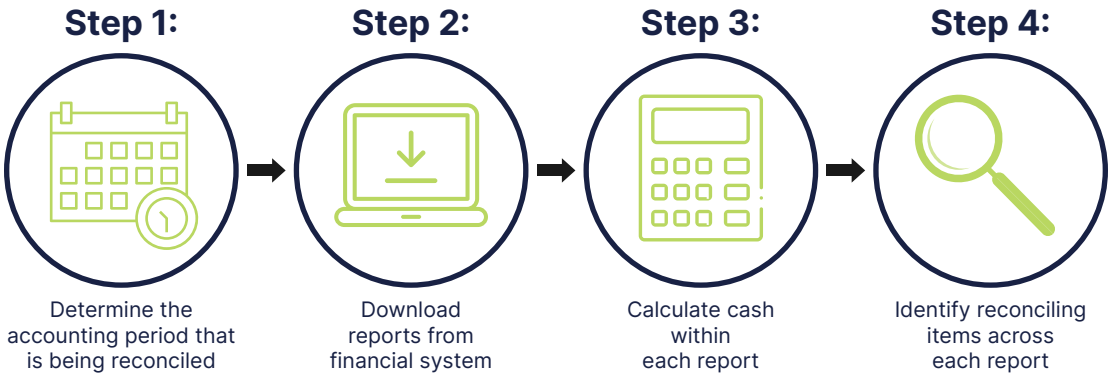
How to Perform a Cash Reconciliation

A comprehensive cash reconciliation should include a 4-way match across the following financial systems. We described these systems in detail in Chapter 2: Introduction to Cash Reconciliation.

- Billing System
- Revenue Recognition System
- Payment Processor
- Bank

4 Steps of a Cash Reconciliation

How to Perform a Cash Reconciliation: A Step-By-Step Guide for Accountants



Step 1: Determine the accounting period that is being reconciled

Examples include 5/1/2020 - 5/31/2020, 1/1/2019 - 12/31/2019, or even 4/15/2020 - 5/15/2020.

Step 2: Download reports from financial systems

Billing System (Cash Report):

All sales transactions that occurred within the accounting period.

Revenue Recognition System (Cash Report):

All sales transactions processed through the system within the accounting period. Download all sales transactions (e.g. cash), not all revenue that was recognized in the accounting period. This is because revenue will include sales from prior period as well.

Payment Processor (Payout Report):

All payouts from the payment processor within the accounting period. Payouts are cash transfers made from the company's payment processor to the company's bank account. Payment processors typically generate payouts in batched quantities. This means that sales transactions from multiple days can be batched into a single payout (e.g. sales from 2/15 and 2/16 are batched into one payout on 2/16).

We will need 2 versions of the Payout Report:

1. Payouts net of fees withheld by payment processor
2. Payouts gross of fees withheld by payment processor

Bank (Bank Statement):

Bank statements may include incoming and outgoing cash related to other business activity. The bank statement will need to be filtered to only include transactions from sales.

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Step 3: Calculate cash within each report

In Example #1, we demonstrate how to calculate the total cash within each system.

For most subscription businesses, revenue is recognized gross of any fees incurred related to the sale (e.g. payment processor fees) and net of any taxes collected.

Step 4: Identify reconciling items across the report

Compare cash between Billing System and RevRec System

These should match when reviewing the same accounting period.

Compare cash between Billing System/RevRec System and Payment Processor payouts

We will generally see differences here. As mentioned earlier, payouts are batched and can include sales transactions from more than 1 day (e.g. sales from 2/15 and 2/16). In order to reconcile, we need to identify the payouts that include transactions outside of the accounting period in question (e.g. a payout on 3/1 that includes transactions from 2/28). Once those payouts are identified, we need to exclude the specific transactions outside the accounting period from the total payout amount. These excluded transactions are the reconciling items for identified differences.

Compare Payment Processor payouts and Bank cash

We will generally see differences here as well. This is due to payments from the payment processor that are in-transit. These in-transit payments will be the reconciling items for identified differences. See Example #2.

EXAMPLE #1:

In March, Company made $2,000 in sales and charged 6% taxes. Payment processor charged a 3% processing fee.

ANSWER:

How to Calculate Total Cash for a Cash Reconciliation

	Billing System	RevRec System	Payment Processor	Bank*
(plus) Sales	$2000	$2000	$2000	-
(plus) Taxes	$120	$120	$120	-
(minus) Processing Fees	-	-	$60	-
(equals) Total Cash	$2120	$2120	$2060	$2060

**Bank receives $2060 in cash from Payment Processor.*

EXAMPLE #2:

The payment processor creates and sends a payout of $100 to the bank on 3/31 at 11:50pm EST. The bank receives and records the cash receipt on 4/1 at 7:00am EST. For the accounting period 3/1 - 3/31, the payment processor cash will include the payout of $100, while the bank statement will exclude the receipt of $100.

Chapter 5:

How to Perform a Cash Reconciliation - A Real-Life Example

Scenario:

Widget Company is an online store and sells one-year subscriptions for access to Widget's photo editing software. Widget conducts all business in USD currency. The Widget Company accounting team is closing the accounting period 3/1/20XX - 3/31/20XX, and will conduct a cash reconciliation to ensure that cash is complete and accurate for the period.

Step 1: Determine the accounting period that is being reconciled

3/1/20XX - 3/31/20XX

Step 2: Download reports from financial systems

Download Billing System sales transactions that occurred from 3/1 to 3/31.
Click here to view an example Billing System report.

Download RevRec System sales transactions that occurred from 3/1 to 3/31.
Click here to view an example RevRec report.

Download Payment Processor Payout Report, gross & net of fees, from 3/1 to 3/31.
Click here to view an example Payment Processor Payout report.

Download 20XX-03 Bank Statement. Filter for only bank transactions received from sales.

Click here to view an example full Bank Statement.
Click here to view an example Bank Statement filtered for sales.

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Step 3: Calculate cash within each report

Using the example reports on page 15, the total cash are as follows:

System	**Total Cash** (USD)	**Differences**
Billing System	$268,981.70	
Revenue Recognition System	$268,981.70	$0
Payment Processor Payouts (gross of fees)	$262,652.86	$6,328.84
Payment Processor Payouts (net of fees)	$257,518.30	$3,012.21
Bank (sales only)	$254,506.09	

When calculating cash from the Billing System, use total cash net of discounts and taxes.

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Step 4: Identify reconciling items across each report

Let's identify reconciling items for the differences noted in step 3 on the previous page.

A **Compare cash between Billing System and RevRec System**
No differences

B **Compare cash between Billing System/RevRec System and Payment Processor payouts (gross of fees)**
See Example #3.

C **Compare Payment Processor payouts (net of fees) and Bank cash**
See Example #4.

Once all reconciling items have been identified, you can get comfort that cash and revenue balances are reported accurately.

Note: These examples illustrate the complex process of comparing cash between Billing/RevRec System and Payment Processor. On the payout level, accounting typically cannot tie back to Billing/RevRec reports unless they have all the underlying transactions for each payout. But for companies with 100k+ transactions each month, this process can quickly become tedious and unmanageable in Excel.

Ideally, a RevRec system should have a cash matching feature in place. This will enable accountants to identify which payout transaction is associated with which RevRec transaction.

EXAMPLE #3:

The total cash difference is $6,328.84. Reconciling items are as follows:

-$5,541.61 from payout_id po_dks992lmqw is excluded from Billing System/RevRec System and included in Payout report. We need to exclude these transactions because according to the transactions detail (Payment Processor Payout report, Page 2) they were created in 20XX-02.

$11,870.45 from payout_id po_irudne4k234 is included in Billing System/RevRec System and excluded from Payout report. This payout is from the 20XX-04 Payout report. Because this payout was created in the beginning of the month, it is likely that some transactions within this payout are for 20XX-03 and must be included in this reconciliation. Therefore, we need to dig into the transactions detail (Payment Processor Payout report, Page 3) to sum the total transactions created in 20XX-03.

EXAMPLE #4:

The total cash difference is $3,012.21. Reconciling items are as follows:

-$8,938.12 Bank deposit on 3/1/20XX is excluded from Payout report and included in Bank statement. We need to exclude this Bank deposit because it is a payout from 20XX-02. In this example, we do not include prior month payouts. However, when performing a cash reconciliation for your business, you must review prior month payouts to determine which amounts to exclude.

$11,950.33 from payout_id po_3985nsld3ss is included in Payout report and excluded from Bank statement. This is a deposit-in transit from Payment Processor created on 3/31/20XX and scheduled to arrive on 4/1/20XX. Because we reconcile based date created, we need to include this payout.

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Chapter 6:

Most Common Problems When Performing a Cash Reconciliation

Foreign Currency

In today's global economy, companies almost always operate in more than one currency: Companies sell to customers all over the world, intercompany transactions between subsidiaries, and interactions between the company, banks, and payment processors, just to name a few. Although they are just normal business activities, these transactions cause currency differences on various levels.

Before we go over an example, below are relevant terms you will need to be familiar with:

Transaction Currency: This is the currency in which the transaction originated in.

Functional Currency: IFRS Standard IAS 21 and FASB ASC 830-10-45-2 define functional currency as "the currency of the primary economic environment in which the entity operates (ie the environment in which it primarily generates and expends cash)." It is also the currency that the entity or company would use to report stand-alone financials. Companies can have more than one legal entity with different functional currencies per entity.

Settlement Currency: Also known as payout currency, settlement currency is defined as the currency used by the bank account and the payment processor.

In the following example, determine the appropriate transaction, functional, and settlement currencies Widget Company should use. For simplicity purposes, we are ignoring processing fees in this example.

EXAMPLE #5:

Widget Company is an online store that sells one-year subscriptions for access to Widget's photo editing software. Widget currently only sells its products in the US, Canada, and Australia, and allows customers to complete purchases in one of three currencies: USD, CAD, AUD.

Widget's Legal Entity structure requires all customers in the US and Canada to be recorded in the US-based subsidiary (Wid-US), while all customers in Australia are recorded in the International subsidiary (Wid-Intl). Financial statements for Wid-US and Wid-Intl are prepared in USD and AUD, respectively. Widget's payment processor and bank both only operate in USD.

On 3/1, a customer located in Perth, Australia purchased a one-year subscription for $100 and elected to pay in CAD.

ANSWER:

Transaction Currency: $100 CAD
Although the customer is in Australia, he can opt to pay in USD, AUD, or CAD. This customer chose to pay in CAD.

Functional Currency: $109.94 AUD
Because this customer is located in Australia, the sale must be recorded in the international subsidiary (Wid-Intl), which has a functional currency of AUD. Exchange rate on 3/1 is 1 CAD to 1.0994 AUD.

Settlement Currency: $71.72 USD
The payment processor and the bank operate in USD. Therefore, the payment processor will be required to convert the $100 CAD into USD in order to deposit the cash into the bank account. Exchange rate on 3/1 is 1 CAD to 0.7172 USD.

Foreign exchange

When there are foreign currencies, there will be foreign exchange (forex or FX). As shown in Example #5, the 3 different currencies all require FX rates depending on the interaction.

FX rates fluctuate day over day. Changing FX rates will also impact a company's realized gain/loss on its financial statements.

FX Gain/Loss

Realized gain or loss indicates that the customer has settled the invoice or that the company has settled the refund. FX gains and losses are primarily driven by changes within the functional currency. Gains and losses are reported on the income statement, therefore FX differences in functional currency (the currency used to prepare financial statements) will be the primary driver of foreign exchange.

Timing differences

As seen in the real-world example in Chapter 5, timing differences across the various financial systems will cause differences in cash. These typically include differences between Billing System/RevRec System and Payment Processor payouts, as well as Payment Processor payouts and Bank cash.

These timing differences become more prevalent in companies with small dollar, high transaction volumes. Therefore, it is essential to perform a cash reconciliation to identify the reconciling items across each report.

Timing differences are often tedious to identify at month-end, especially when cash reconciliations are performed manually. Companies must consider automating their cash reconciliation and cash matching process to decrease risk of manual errors.

In the following example, determine the appropriate journal entries to be booked to the general ledger.

EXAMPLE #6:

On 3/1, a customer located in Perth, Australia purchased a one-year subscription for $100 and elected to pay in CAD. On 3/5, the customer cancels the subscription and receives a full refund.

The exchange rate on 3/1 is 1 CAD to 1.0994 AUD.

The exchange rate on 3/5 is 1 CAD to 1.0810 AUD.

ANSWER:

Date	Account	DR	CR
3/1	Cash (FX 1.0994)	$109.94 AUD	
	Deferred Rev (FX 1.0994)		$109.94 AUD
3/5	Deferred Rev (FX 1.0994)	$109.94 AUD	
	Cash (FX 1.081)		$108.10 AUD
	FX Gain		$1.84 AUD

Defining reasonable thresholds for differences

When performing cash reconciliations at the aggregate-level, it is possible that you may not be able to identify differences down to $0. In such instances, accountants must define allowable differences an acceptable threshold.

A threshold of <1% may be appropriate for some SaaS companies but not others. To establish threshold levels, accountants need to rely on professional judgment and general rules of thumb. They must also consider the dollar amounts, percentage, and risk of material misstatement. An auditor's opinion may be helpful, but ultimately it is the accountant who must determine the reasonable threshold.

Remember that it is all relative.

Identifying discrepancies and reconciling items

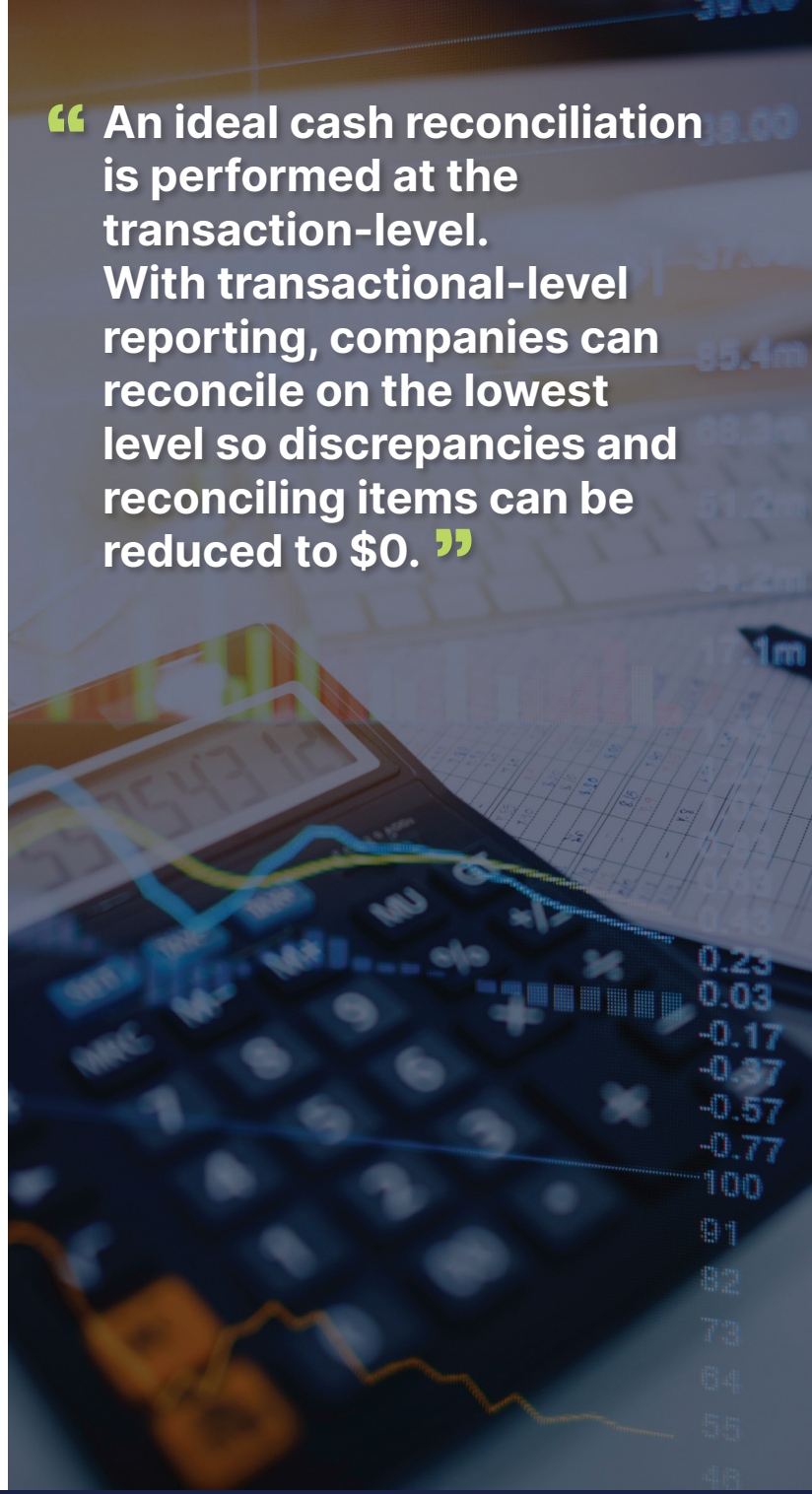
Companies with subscription business models typically have high transaction volumes, making transaction-level cash reconciliations extremely difficult without automation or finance tech stack modernization.

Aggregate reporting

When dealing with high transaction volumes, aggregate reporting is usually the default for accountants because they do not have a cash matching system. Aggregate level reporting allows accountants to perform high-level cash reconciliations and obtain comfort that sales and cash across an entity's financial systems are complete and equally accounted for. However, aggregate reporting does not allow accountants to drill down into specific transactions to easily identify discrepancies and reconciling items.

Transaction-level reporting

An ideal cash reconciliation is performed at the transaction-level. An automated cash matching system will be able to link cash from the various financial systems at the transaction level and identify specific differences. With transactional-level reporting, companies can reconcile on the lowest level so discrepancies and reconciling items can be reduced to $0.



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