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The Check 21 Act and Its Impact on Check Fraud

The Check 21 Act may be the reason entities have not been reviewing canceled checks. But taking the extra step to review canceled checks with your monthly bank statement can save an organization from costly and potentially devastating fraud.

By **Kyle Anne Midkiff** | July 20, 2020 at 12:18 PM


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Many embezzlement investigations that I have conducted share a common element. The common element is that if someone at the entity had reviewed the canceled checks on a timely basis, they would have detected that unauthorized checks were being issued to the person preparing and processing the payments. The Check 21 Act may be the reason entities have not been reviewing canceled checks. But taking the extra step to review canceled checks with your monthly bank statement can save an organization from costly and potentially devastating fraud.

Check 21 Act

The "Check Clearing for the 21st Century Act," commonly known as "Check 21" or "Check 21 Act," took effect on Oct. 28, 2004. The concept for Check 21 originated from the Expedited Funds Availability Act of 1987, in which Congress directed the Board of Governors of the Federal Reserve System to consider establishing regulations requiring Federal Reserve banks and depository institutions to provide for check truncation, in order to improve the check-processing system. The terrorist attacks on Sept. 11, 2001—which caused major delays in check processing due to grounded planes (halting the transport of canceled checks to Federal Reserve banks)—was the catalyst that led to the passage of Check 21.

The purposes of Check 21 were defined in the act as follows:

- To facilitate check truncation by authorizing substitute checks.
- To foster innovation in the check collection system without mandating receipt of checks in electronic form.
- To improve the overall efficiency of the Nation's payments system."

Substitute Checks

Check truncation is facilitated by the creation of a negotiable instrument referred to as a "substitute check," which is provided to banks that want to continue receiving paper checks rather than electronic files.

The substitute check includes all the information contained on the original check and is legally equivalent to the original check. Check 21 permits banks to provide either original paid checks or substitute checks with customer account statements.

Funds Availability After Check 21

On the positive side, Check 21 has allowed entities and individuals to receive and have access to their funds sooner.

But it also has hampered those entities and individuals who previously “played the float.” Float is the amount of time it takes for money to move from one account to another. Playing the float is the process of writing a check with no bank balance covering the check in the hope there will be funds in the bank when the check clears. In the past, it was easier to take advantage of float time between when a check was written by the payer and when the funds were transferred to the payee. Check 21 has had the practical effect of eliminating that opportunity.

There can be a fine line between playing the float and actual check kiting. Check kiting is the illegal act of knowingly writing a check from a bank account without sufficient funds and depositing it into another bank account. Money is then withdrawn from the second account before the original check has cleared. Check kiting is a federal crime typically prosecuted under 18 U.S.C. Section 1344, Bank Fraud, and may also be prosecuted under state law.

Check 21 and Its Impact on Check Fraud

Prior to the enactment of Check 21, almost all individuals, businesses and nonprofits received their canceled paid checks with their monthly bank statements. At businesses and nonprofits that practiced good internal control procedures, a person other than whoever wrote and recorded the checks would receive and open the monthly bank statement (i.e., segregation of duties). He would thumb through the canceled checks to see what checks were written, to whom they were written, and the amounts paid. They could also flip over the canceled checks to see if the endorsements on the back were consistent with the payees. To the extent there were any improper checks issued and paid, they could be discovered timely.

Subsequent to the enactment of Check 21, many businesses and nonprofits elected not to receive their canceled paid checks, even though many banks will provide copies with the bank statements for minimal fees. While check copies can be viewed online, many times the only individual taking this step is the person who wrote or processed and recorded the checks originally. This lack of segregation of duties has led to numerous situations, especially in small businesses and nonprofits, where check fraud is possible and may continue for years. Often times, falsified checks are overtly written to the perpetrator as the payee, with no attempt to mask the fraud.

As an internal control feature, many entities have implemented Positive Pay. Positive Pay is a service that matches the bank account number, check number and dollar amount of each check presented for payment against a list of checks previously authorized and issued by the entity. All three features of the check must match exactly or the bank will not pay and will follow up with the payer for additional information. However, the Positive Pay process does not match or compare the payee of the check. As a result, a check can be falsified by substituting or switching a payee’s name in the preparation of the check, and it will not be detected by Positive Pay.

Clever bookkeepers and accounting clerks usually know their check writing systems well and can find ways to circumvent the system to change the payee’s name when the check is printed. Frequently, the cash disbursement journal or check register will reflect the name of the original, intended payee, such as a legitimate vendor of the organization.

Alternatively, the payee in the check register might be modified for purposes of printing the check and then changed back to a legitimate vendor after the fact. These types of alterations can be uncovered in special reports generated by the accounting software.

A third method of check fraud is to issue a check but never record it in the general ledger.

Organizations sometimes make the mistake of thinking they have good internal controls and that their cash accounts are safeguarded because bank reconciliations are timely completed and reviewed. However, when the operating account is reconciled, only the check numbers and paid amounts that cleared the bank appear on the bank statement—not the actual copies of the cleared checks showing the true payee. Even the reviewer of the bank reconciliation (frequently a supervisor) often looks only to see whether the account reconciles and whether there are any outstanding items. Time is not taken to look at paid cancelled check copies.

How to Safeguard Your Organization From Check Fraud

So, a word to the wise to help safeguard your organization: Review your paid canceled check images to see whom your organization actually paid. If you see something questionable, follow up on the validity of the payment to that individual or company by reviewing the invoice, purchase order and payment history with that vendor. Also consider obtaining a copy of the back of the check from the bank to review the endorsement. The review of canceled check copies online is a simple, yet effective control that is not very costly to implement. Failure to do so can be extremely costly, as many organizations have learned the hard way.

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