

Auditor of State Bulletin

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TO: All Public Offices
All Independent Public Accountants

FROM: Betty Montgomery
Ohio Auditor of State

SUBJECT: Check Clearing for the 21st Century Act

This Bulletin discusses key provisions of the federal “Check Clearing for the 21st Century Act” (Check 21),¹ which affects all units of government that use the banking system. This Bulletin also addresses protestation rights under the new law and control procedures that should be implemented due to changes caused by Check 21.

The purpose of the law, which became effective on October 28, 2004, is to allow banks to process checks more efficiently by facilitating the exchange of checks via electronic images. Moreover, banks are no longer required to issue or return the original checks to customers. The Auditor of State’s Office (AOS) expects that the vast majority of banks will avail themselves of this law and that customers of banking services, such as governments, will no longer receive their cancelled checks.

The Check 21 Act supersedes any federal or state law to the contrary. Correspondingly, this Bulletin supersedes Auditor of State Bulletin 96-006, *Electronic Imaging of Checks*.

General Provisions

Now that Check 21 is effective, any bank in the check-cashing/payment system (e.g., bank of first deposit, intermediary depository bank, collecting bank, etc.) will be able to remove the original check and replace it with an electronic image of the front and back of the check. The new law permits banks to process checks electronically with other banks as long as agreements are in place governing the electronic exchange. At any point in the process, however, a bank may use the electronic image to create a “substitute check” for a bank that chooses to continue receiving paper checks.

Under Check 21, this substitute check has the same legal effect as the original paper check. A substitute check is a paper reproduction of the original check that

- ✓ contains an image of the front and back of the original check;

¹ P.L. 108-100 , 117 STAT 1177-1194, 12 USC 5001-5018

- ✓ bears a magnetic ink character recognition (MICR) line containing all of the information appearing on the original check's MICR line, with certain exceptions;
- ✓ conforms, in paper stock, dimension, and otherwise, with generally applicable banking industry standards for substitute checks; and
- ✓ is as suitable for automated processing as the original check.

A substitute check that meets these requirements and bears the following legend is considered to be the legal equivalent of the original paper check: "This is a legal copy of your check. You can use it in the same way you would use the original check." This Bulletin includes an example substitute check as Appendix A.

In accordance with the new law, no bank is *required* to provide governments with either the original cancelled check or the substitute check. Based on discussions with banking industry representatives, however, banks are likely to provide customers with a substitute check upon request. Further, it is possible that banks may ask customers (e.g., governments) to accept some other record of checks charged to an account. For example, banks may provide a listing of check charges on a periodic statement and/or provide electronic images [or a CD-ROM listing or images of the checks] along with the periodic statement. Each of these types of records [CD-ROM listing or images of check (front and back) or substitute check] is acceptable to AOS, provided that appropriate internal controls are in place.

Neither Check 21 nor its regulations indicate whether a bank may charge the customer for a copy of the original check or the substitute check. To that end, customers might be charged to receive either of these. Therefore, AOS suggests that governments carefully scrutinize any communication from banks regarding service charges and to examine their service agreements (including amendments) with banks.

Rights to Protest Improper Charges

Under Check 21, "consumers" have the right to the expedited re-credit and other consumer protection features provided by the law. The regulations define a consumer as a "natural person," meaning a living individual person. Consequently, no government is a "consumer" as defined in these regulations. Nevertheless, governments maintain their current protections under the Uniform Commercial Code² to protest improper charges. Thus, given the changes caused by Check 21, governments should carefully examine their service agreements with banks to understand their rights to dispute improper charges and to recoup any fees that might have been assessed during the check-cashing/payment process.

Control Procedures

While anything other than an original check or warrant, including a substitute check, will be unable to capture some of the physical security features contained in original checks (e.g.,

² See generally Article 4, UCC; § 4-406.

digital watermarks, handwriting characteristics, ultraviolet inks, etc.), the increase in processing speed created through electronic check exchange should help reduce opportunities for fraud. Check 21 will also reduce the number of physical checks in circulation from which account and routing information can be stolen. Notwithstanding these benefits, control procedures are vital to help protect governments against erroneous charges, theft, and fraud.

For governments that do not receive their cancelled original or substitute checks, AOS suggests these governments request that their banks send images of the **front and back** of all issued checks. This will enable governments to review and scrutinize the transactions and ensure that the payees as well as the various endorsements are appropriate. As monthly [or other periodic] bank statements are received, reconciliation between check numbers and the amounts paid should be conducted promptly. If questionable items are identified, governments should immediately request their bank investigate these items for possible adjustment to the government's account. Furthermore, a government may want to request³ a substitute check or the best available source document from the bank (e.g., copy of the front and back of the check) when a questionable item is identified that requires investigation.

Online Banking

When governments write checks, they are providing information to the receiver of those checks [and others, including the government's own employees] with their bank account number and their bank's Routing Transit Number. Disseminating such information increases the possibility that it could be used for non-governmental purposes. With the introduction of Check 21, governments may consider using electronic bill paying systems to the extent feasible (i.e., online banking).

When governments conduct online banking, it is critical that appropriate controls be established over the transactions similar to those established for paper transactions. No one individual should be responsible for writing checks, whether online or with paper, reconciling the related bank accounts, and entering the related transactions into the books of account. Furthermore, access should be controlled so that only authorized persons are able to initiate transactions. Access might be accomplished by a combination of password or other program controls and physical controls, such as access to a computer or terminal that processes such transactions. Finally, appropriate paper or electronic copies of transactions and balances should be retained for audit inspection.

Other Control Ideas

- ✓ Request banks to imprint the check number on the back of the check. This will enable governments to determine that the images received from the bank do, in fact, match-up with the corresponding fronts of the checks.

³ Banks may require these requests in writing.

The AOS encourages positive pay as a method to combat certain cybercrimes.

- ✓ Do not maintain blank check stock as checks can be reproduced easily using computer software. In the event that blank check stock is not kept, then governments will no longer need to implement controls designed to secure blank, physical checks.
- ✓ Consider using a “positive pay” system, whereby a government sends a copy of the authorized check (electronic or paper) to its bank to be compared with the check that is later presented for payment. If there is a match, the payment is approved; if there is not a match, it is rejected.
- ✓ Governments using electronic banking services may wish to “block” or “filter” ACH [Automated Clearinghouse] transactions. These requirements are quite technical and beyond the scope of this Bulletin. Governments should discuss these control mechanisms with their banks, if applicable.

Governments as “Banks”

per footnote 4 below, enables

Check 21 ~~may enable~~ the State and “a unit of general local government” to act as “banks”⁴ and remove⁵ the original cancelled checks [or warrants] and, in turn, work with their bank to create electronic images or substitute checks⁶ for further processing. Units of general local government as defined include cities; counties; villages; and townships. ~~While it is not clear as of the date of this Bulletin what effect Check 21 has on governments that act in this capacity,~~ AOS recommends that governments that intend to “remove” checks and warrants should consult their legal counsel as to their rights and responsibilities under the new law. AOS also recommends that these governments ensure that all physical and electronically imaged checks are maintained in accordance with Ohio’s public records law as well as the particular government’s record retention schedule.

Contacting Legal Counsel

As a result of the complex laws and regulations affecting customers’ rights and responsibilities under the Act and existing banking laws and regulations, governments should consult with their legal counsel on the impact of Check 21. Further, AOS recommends governments consult legal counsel if their banks request modifications to account agreement(s).

⁴ See 12 CFR Section 229.2(z)(5), “Paying Bank” means...the state or unit of general local government on which a check is drawn and to which it is sent for payment or collection. Check 21 refers to these units of government as “payors.”

⁵ “Remove” in this context refers to the process of taking the check/warrant out of the stream of the check-cashing process and later destroying it in accordance with an agreed-upon timeframe.

⁶ See Federal Register/ Vol 69, No. 149, page 47290, “Supplementary Information.” “Banks” are *permitted* to send “substitute checks” in lieu of paper checks at any step of the process and “banks” in the process are required to accept them.

Thus, AOS strongly encourages that governments adequately plan and prepare for the implementation of the Check 21 Act, and hope that this Bulletin is of assistance to you in that effort.

If you have any questions concerning the legal requirements of Check 21 or its regulations, AOS suggests governments contact their respective legal counsels. If you have any questions specifically pertaining to this Bulletin, please contact AOS's Accounting and Auditing Support Group at (800) 282-0370.

Betty Montgomery
Ohio Auditor of State

Appendix A – Example Substitute Check

➤ Gray Scale – Personal Size

011500120
 01/04/2002
 8587408979
 This is a LEGAL COPY of your check. You can use it the same way you would use the original check.

053000183 01/03/2002 944650081 1800539446

JAMES C MORRISON
 MARY B MORRISON
 1766 SHERIDAN DRIVE
 YOUR CITY, STATE 09001

145

DATE *Jan 1, 2002* 00-87807000
008892

PAY TO the order of NORTH POLE, INC. \$ 295.45

Two Hundred Ninety Five and 45/100 DOLLARS

Your Bank
 YOUR CITY, STATE 12345

MEMO *Gas/ies*

James C. Morrison

@000087894@ 12345678@ 0145 @0000029545@

@000087894@ 12345678@ 0145 @0000029545@

0530 01183 01032902
 NORTH POLE, INC. N.A. CO
 042017E, NC 1175 882
 1800539446

>031000011< 01/02/2002
 944650081

JAN - 2 02

@01000011@
 FIRST UNION NATL BKR 813
 PHILADELPHIA PA 191022802
 78158830233

DO NOT SIGN/WRITE DATA BELOW THIS LINE
 FOR FINANCIAL INSTITUTION USE ONLY

ENDORSE HERE:

FOR DEPOSIT ONLY

FIRST UNION NATIONAL BANK

ACCOUNT 1234567890123

NORTH POLE, INC.

053000183 01/03/2002
 1800539446
 011500120 01/04/2002
 8587408979

↓ Do not endorse or write below this line. ↓