PART I

Core Functions

Part I addresses the basic functions handled in virtually every accounts payable department. Basically this covers the entire procure-to-pay cycle. We begin by looking at the important issue of internal controls. Without appropriate controls, the door to duplicate payments and fraud is opened wide. The section then investigates the invoice handling process as well as the ensuing payment process before delving into the processes that affect the function.

Few people outside of accounts payable understand the negative ramifications of exception processing. By investigating what can go wrong when items are handled outside the normal invoice/payment processing routines, you will understand why it is imperative to minimize the number of exception items allowed.

Another issue that few companies like to talk about in public is the level of duplicate and erroneous payments that occurs at their companies. We'll also provide suggestions to help you minimize this problem.

Handling vendors correctly is also an overlooked issue. Not only vendor relationships, but also the way data related to vendors is handled. The very serious issue of the master vendor file is investigated, and proper techniques are shared.

Finally, there is the question of discounts, early-payment discounts, and the occasional deduction that will be taken against an invoice. Best practices for these issues are discussed because the proper handling of discounts and deductions will affect the productivity of your accounts payable department.

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Internal Controls in Accounts Payable

The What-Happens-in-Vegas-Stays-in-Vegas philosophy does not apply to accounts payable or purchasing or treasury or receiving, no matter how much some of these groups would like to operate in their own little fiefdoms. In fact, in this post–Sarbanes-Oxley era, everything is transparent when it comes to corporate operations. This strategy appears to be infiltrating private companies and not-for-profits as well as public companies.

If internal controls and processes break down between accounts payable and purchasing, the ramifications are likely to be felt all the way down to the bottom line. Nothing good can come out of these collapses. Unless they are intimately involved in the nitty-gritty of the accounts payable operations, only a few savvy controllers and CFOs realize the far-reaching impact of just a few poor, seemingly minor, decisions related to the accounts payable process.

Without this insight, many consider the demands of the accounts payable staff to be controlling, not seeing the forest for the trees, or worse. However, I think that when the implications are spelled out, you will realize that the accounts payable manager who demands, for instance, that all invoices be sent directly to accounts payable, is not a control freak but rather one who is concerned about earning early-payment discounts. Similarly, the one who refuses to issue Rush checks in all but the most dire circumstances is not being difficult but rather trying to ensure that the company does not make duplicate payments or, worse, pay a fraudulent invoice.

Now that accounts payable is no longer considered a back-office, non-value-added function, savvy business managers know that in order to run a leading-edge company, it is crucial that proper attention be paid to the accounts payable function. Now, before you turn the page thinking I am making a big fuss over nothing, let me explain what can go wrong when the accounts payable function is ignored. Then we can talk a little bit about the guidelines that will make your company's payment process best-in-class. Before we start, we'd like to point out that in most organizations, accounts payable includes travel and entertainment (T&E), 1099s, unclaimed property, sales and use tax, and value-added tax (VAT) reclaim.

IGNORE ACCOUNTS PAYABLE AT YOUR OWN PERIL

Recently, Wal-Mart and American University were in the news in ways both would probably have preferred to avoid. In the Wal-Mart case, one of its top lieutenants, Tom Coughlin, was accused of expense account abuse. A similar allegation led to the ousting of American University president Benjamin Ladner. In the latter case, the University was so incensed by Ladner's activity that it took unusual action. Newspaper accounts indicate that the University reported Mr. Ladner's excess spending as income to the IRS retroactively. While the amounts of money involved might be high to the average person, the institutions in question can probably afford the hit. What they did not need was the excessive adverse publicity that surrounded these events.

Bad publicity is only the beginning of the negative consequences for poor or weak accounts payable practices. The financial implications can be far more damaging. For starters, poor controls in the accounts payable process can lead to duplicate payments (and, no, the other side does not automatically give the funds back), open the door for fraud, lead to aggravation with state auditing groups, and for public companies, cause trouble with Sarbanes-Oxley audits.

Although most companies don't like to admit it in public, duplicate and erroneous payments are a huge problem in the corporate world. A whole industry has sprung up around the issue. These numerous third-party firms will uncover and retrieve duplicate payments on a contingency basis. While that business has gotten quite competitive in recent years, the fact that this industry exists is a signal of the extent of the problem. A high percentage of these duplicate payments arise from poor practices in accounts payable, purchasing, and receiving, as well as the document flow among the three. In many instances, the accounts payable manager knows the right way to process invoices and payments but lacks the clout to enforce the changes needed to right these wrongs.

THE FRAUD PROBLEM

Fraud can take several shapes. Check fraud is a colossal problem in the United States. Experts estimate that financial institutions lose about $12 billion a year in check fraud alone. And that's just the loss at banks. Now, if you are thinking that you do not have to worry about your check processes because your bank will eat any losses, think again. The problem has gotten so out of control that changes have been made to the Uniform Commercial Code (UCC) to address the problem. Now the loss is borne by the party that was best able to prevent the crime. If a company does not exercise "reasonable care," it will be deemed liable for the loss.

Check fraud is just the beginning of the fraud issue for organizations. Phony invoice fraud has been growing, vendor fraud has always been an issue, and employees who are knowledgeable about weaknesses in existing controls have long been known to exploit those loopholes for personal gain. If you are thinking that most of your employees are long-term trusted individuals, so this is not a problem in your organization, let me share with you a little-known fact. Most employee fraud is committed by long-term trusted employees.

STATE AUDITING GROUPS

Most states are desperate for income and are vigorously looking for ways to increase that income without increasing taxes on the voters who elected the state officials. What may come as a shock is the way the states are generating the shortfalls in their budgets. Two of the techniques could hit your bottom line if your organization is not handling them correctly.

The first is unclaimed property. Every organization is supposed to turn over to the state any unclaimed property it may have. That includes uncashed checks (including payroll). That's right; uncashed checks are supposed to be turned over to the state. Writing these checks off to miscellaneous income is a huge no-no. The relevant dates and amounts vary by state. The much ballyhooed business exemption is so weak, it is rarely worth considering. States are hiring third-party auditors who often work on a contingency basis. These firms often work for more than one state. So if your company is not complying with the rules, it could be audited numerous times as the auditors for each state show up on your doorstep. If the auditors find a shortfall, your organization will not only have to pay what is owed, but it will also be hit with penalties and/or fines. And they audit more than the current year.

A similar situation exists for sales and use tax, where the abuse may not be as high, but the rules are certainly more complex, given the over 7,000 taxing authorities in the United States alone.

SARBANES-OXLEY IMPACT

As public companies across the country struggle with Sarbanes-Oxley (S-Ox) audits, they are discovering that inadequate controls of the accounts payable function will get them dinged in their S-Ox audit. That's right; doing things poorly in your payment process can lead to trouble with Section 404 on Internal Controls. Interestingly, in a recent poll conducted by *Accounts Payable Now & Tomorrow,* a newsletter for professionals interested in payment issues, many companies (both public and private) admitted that they had changed some of their processes as a direct result of the passage of the Act. Over half conceded that they had tightened up their T&E processes.

Not only public companies are affected by the Act. Private companies are being required to conform to the strictures of the Act by key suppliers, key customers, and their financial institutions.

This discussion is not meant to scare those who have been ignoring their accounts payable processes, but rather to serve as a wake-up call before your bottom line is adversely impacted or one of the state auditors shows up on your doorstep with a big, fat penalty bill. Even if your organization can easily afford to pay the fines, who needs that aggravation? Rarely is this seen as a good career move by one's bosses.

A MARRIAGE MADE IN HEAVEN—NOT!

As alluded to previously, purchasing and accounts payable often do not see eye to eye on many issues. Disagreements between accounts payable and purchasing account for a large percentage of the problems that occur in accounts payable. Purchasing wins 90% of these disagreements—often to the bottom-line detriment of the organization. Some of the things purchasing does that cause payment problems include:

- Purchase orders (POs) are not completely filled out
- POs are not given to accounts payable
- POs are issued after invoices are received
- Special deals are negotiated and never communicated to accounts payable
- Invoices forwarded to purchasing for approvals are not reviewed for weeks
- Purchasing tells vendors it had sent approved invoices back to AP weeks earlier when in fact they are still sitting in purchasing

As you might imagine, from accounts payable's point of view, it is unfortunate that purchasing is not encouraged to see the problems that arise in accounts payable when some of these issues are not dealt with. Unfortunately, the ramifications of ignoring these issues transcend hurt feelings in accounts payable. The consequences fall right to the bottom line.

So exactly how should the accounts payable function work, especially in conjunction with purchasing? Let's take a look.

IDEAL ACCOUNTS PAYABLE FUNCTION

The first step in the invoice process starts when an item is ordered and purchasing submits a purchase order. In our ideal world, the PO is sent to the supplier. At the same time, it is either sent to accounts payable or entered into a database that can be accessed by accounts payable. The key factor in making this process work from the start is completely filling out the PO. Just in case I haven't beaten that point into the ground, let me reiterate that many problems in the payment process originate because the PO is not completed but rather submitted with partial information.

The next step in the process revolves around the receiving dock. When the goods arrive, they should be checked against the packing slip to make sure everything that is indicated on the packing slip was in fact delivered. Performance in this arena at many companies is spotty. Some do a magnificent job, but others simply sign off on goods received, never doing any checking whatsoever. The packing slip is then either sent to accounts payable for matching or imaged, and the image is forwarded for use in the payment process.

When the invoice arrives, it is matched to the packing slip and purchase order, and if all is in order, the invoice is paid. The phrase "when the invoice arrives" needs further examination. It is not nearly as simple as it seems.

"WHEN THE INVOICE ARRIVES"

The first salient point that should be addressed is where the invoice should be directed. There is no definitive answer other than that invoices should all be directed to the same place. That destination can either be the accounts payable department or the original purchaser. There are two schools of thought on this issue.

The first recommends that all invoices be directed to the accounts payable department. The department would then forward the invoice to the approver for review. Before being forwarded, the invoice could be logged. In this manner, accounts payable would have a good handle on where invoices were and could field calls from vendors efficiently. This process works very well when electronic invoicing is used. In a paper-based environment, it is a bit more cumbersome.

For the system of sending everything to accounts payable to work, the invoice must be clearly marked with either a purchase order number or the name of the purchaser. Without such delineating information, much time is wasted trying to figure out who ordered the goods in the first place.

In fact, it is a recommended best practice that if an invoice is received without such information it should be returned to the vendor with a polite letter asking for either a purchase order number or the name of the purchaser. By the way, a side benefit of this approach is that it helps weed out fraudulent invoices.

The second school of thought has all the invoices going to the original purchaser. While at first glance it may seem like this makes it easier for accounts payable, as they only have to deal with it once it shows up in accounts payable with the necessary approval, that is not necessarily the case. For starters, when looking for past-due payments, many vendors begin by contacting accounts payable. If accounts payable has no knowledge of the invoice, the staff cannot help the vendor.

In this scenario, accounts payable also has no knowledge of how long an invoice has been sitting in purchasing awaiting the approval from the purchasing manager. Thus, invoices could be seriously delinquent, and the first accounts payable knows of it is when someone demands a Rush check. The issue of Rush checks will be addressed extensively in Chapter 4, Exception Processing.

Another ugly scenario plays out more than occasionally. Here's what happens: Start by recognizing the fact that reviewing an invoice for payment and approving it are pretty low tasks on most purchasing executives' priority lists. So invoices sometimes sit for a long time without being reviewed. Then when the purchasing manager gets the call from the vendor looking for payment, he goes into action.

Not wanting to admit that he is the hold-up, he approves the invoice for payment (without much review) and puts it in the interoffice mail. And what does this genius tell the vendor? Not wanting to look bad. He says something like, "I sent it back to accounts payable weeks ago. I don't know why those guys haven't paid you." Usually, this dialogue is peppered with a few expletives that are not designed to present accounts payable in a favorable light.

In this hypothetical scenario, the vendor now calls accounts payable in a rage because he believes that accounts payable is responsible for his delayed payment. The conversation with the vendor regarding payment in these situations tends to be less than pretty. So, while on the face of it, having invoices go directly to the purchaser may not save accounts payable as much work as it would seem at first glance. In fact, some would argue that, depending on the cooperation from purchasing, it may even increase accounts payable's workload.

Electronic invoicing will be discussed in the following chapter, so we will not go into it in too much detail here. Suffice it to say that the electronic audit trail that is inherent whenever e-mail is used clears up some of these problems.

SEGREGATION OF DUTIES

One of the most critical features when it comes to controls is the appropriate segregation of duties. With the myriad of different responsibilities that fall under the accounts payable umbrella, appropriate segregation of duties, especially in companies with smaller accounts payable departments, can sometimes be a challenge. This is magnified by the fact that it is not always readily apparent what duties should be segregated.

Segregation of Duties & Sarbanes-Oxley

Sarbanes-Oxley raised the bar when it came to the segregation-of-duties issue. While everyone knew it was important, it was one of those issues that sometimes got ignored in some organizations. Inappropriate segregation of duties is one of the issues that allows insider fraud, sometimes referred to as occupational fraud, to occur. The problem here is that companies are sometimes lulled into a false sense of security because the individual who has the duties that are not properly segregated is a trusted employee.

Well, do you know who most frequently commits fraud? Long term trusted employees. So, do not be lulled by the thought that Joe in Accounting has been with you forever and would never do anything to hurt the organization.

Numerous executives have reported that they have been dinged in their Sarbanes-Oxley audit for not having appropriate segregation of duties. By, the way, the other big area that has emerged as an issue for some organizations, is inadequate documentation. It appears that more than a few firms have not updated their policy and procedures manual in quite some time.

If the segregation-of-duties issue becomes a problem within accounts payable because of staffing size, sometimes parties in other departments can be drafted to address some of the issues. For example, someone in treasury or accounting might get checks signed, handle the bank reconciliations, or be responsible for updates to the master vendor file.

CONTROL ON PAYMENT TYPES

As the business world evolves, new payment technologies are emerging to complement the check and wire transfer methodologies that have long been standard. Companies now use purchasing cards and automated clearinghouse (ACH) payments to complement the traditional payment approaches. Overall, these new payment types make the payment process more efficient.

However, if care is not taken, that efficiency can come back and hit an organization in the face. It has long been known that when payments are made by wire transfer by a department other than the one that issues checks, attention must be given to ensure that a check is not also cut. A best practice recommendation in this area is that one payment type be selected for each vendor.

In other words, a vendor can be paid by either check or wire transfer, but not one method for one invoice and then a different one for the next. With the growth of purchase cards (p-cards) and ACH payments in the corporate arena, this problem has mushroomed. Some vendors who accept p-cards are not able to suppress the printing of invoices. Thus, even though the item has been paid for with the p-card, the invoice still gets mailed.

And you know what occasionally happens when the invoice shows up at the company. The purchaser sometimes forgets that he or she paid for the item with a p-card and approves the invoice and sends it off to accounts payable for processing. Sometimes these invoices show in small print that the invoice has been paid for with the p-card and sometimes they don't. Unfortunately, sometimes these invoices are paid a second time by check.

The multiple payment possibilities provide a ripe area for the firms that specialize in finding duplicate payments. It is recommended that each vendor be set up in the master vendor file with only one payment type allocated. Thus, if a vendor is a p-card vendor, checks are never issued to that entity without numerous overrides and approvals from senior management, as well as a very good explanation from the person requesting the policy violation.

OTHER PAYMENT TYPE CONTROL ISSUES

Limiting payment types to one per vendor is one way to eliminate problems. Another is to make sure that information about all payment types is entered into all applicable systems. If really good controls exist around this issue, the question of whether one or more payment mechanisms are used is of less importance. However, in many systems, there is a loophole in this regard.

When the three-way match discussed earlier in this chapter is completed, many systems close the purchase order. However, if a wire transfer is used, this step is often missed, leaving the purchase order outstanding and available for matching if an approved invoice shows up.

OFTEN-OVERLOOKED ISSUE: SPREADSHEETS

Four out of every five organizations use one or more of the Microsoft Office tools (Word, Excel, Access, and Outlook) in their day-to-day operations of the accounts payable operations in a structured manner. These figures come from a recent *Accounts Payable Now & Tomorrow* poll of its readers. As might be expected, the heaviest reliance is on Excel spreadsheets, but other tools are used heavily as well.

What we did find troubling was how these applications are audited, or should we say, not audited. While 53% include these applications in their standard audits, 47% of the respondents do not have these applications audited. This means there are huge "opportunities" for fraud. Let me give you a simple example of what PinPoint Recovery found when auditing one client for duplicate payments.

Some firms track their escheatable items on an Excel spreadsheet. When bank accounts are closed, as they inevitably are, outstanding checks have to be dealt with. Some organizations leave the accounts open until all the checks clear. Typically, a few checks are never cashed. After proper research they may be deemed escheatable. In this case, at the organization in question, the appropriate information was entered onto an Excel spreadsheet, the accounting entries made, and at the appropriate time, the items were turned over to the state. So, what's the problem you ask?

At the firm in question, someone was changing the entries on the Excel spreadsheets. The change did not cost the company a red cent, so its financial records were never affected. What some crafty individual was doing was changing the name of the company to whom the funds were owed to the name of an individual. If this "adjustment" had not been detected, the individual would then have been able to collect the funds free and clear from the state, and no one would have been the wiser.

Since the process of using Office applications in many organizations grew in an informal manner rather than a structured, planned way, the control issue is often overlooked. Many of the applications developed are workarounds that complement the existing accounting package and are used to track issues that are not addressed by the accounting software. Hence, these applications do not always have the strict controls that other functions have.

In fact, when asked about this issue, many of the poll respondents did not have a formal structure in place. More than a few indicated that there were no controls. "We do not have any formal controls in place since these applications (with the exception of Outlook) are used as needed to compile and convey information not readily available from our main AP software," was a typical response.

SPREADSHEET CONTROL PLAN

Normally, disbursement data is entered in and resides on an online accounts payable application where formal and applicable disbursement controls are in place. However, when the accounts payable data source from a desktop application does not contain essential business controls and documented procedures, then there is a real exposure to both fraud and inaccurate payments. Bob Lovallo, president of PinPoint Recovery, advises companies not to overlook this important area. Here are some of the issues that Lovallo says every company needs to consider:

- Are your critical disbursement sensitive data and files residing on a desktop computer that is secure to prevent the introduction of improper data or revision of proper data?
- Are the data and files protected to prevent unauthorized access that can lead to and result in a fraud?
- Are an audit trail and controls in place that support the integrity of source data and file additions, changes, deletions, and output?
- Do you have an inventory list of such disbursement sensitive files and applications?
- If you do have an inventory, have you performed an ongoing security check and audit for data integrity by determining the correctness of the source data?
- Do you have desk procedures that also include a flowchart indicating what control points are in place to ensure that control and auditability is evident and maintained?
- Do your procedures also address and maintain appropriate segregation of duties?
- Have you tested a portion of original source documents, formulas, report computations, and controls to the desktop application's output?

It is important that information at every step of the process have the appropriate controls in place. You will need to verify the input, the calculations, and the output.

POLICY AND PROCEDURES MANUAL

Because many accounts payable departments have grown gradually or evolved as part of the accounting department, few have a written game plan. Instead, procedures are developed on an as-needed basis, in kind of a hodgepodge manner. Moreover, much of the knowledge about how things work and where information is located often resides with specific individuals. If those individuals get sick or accept another job, the company is left in a lurch.

Every accounts payable department should have a procedures manual, to serve not only as a guide in case of emergency, but also to provide managers with the necessary documentation to demonstrate to management the capabilities of the staff and the work they are handling. Without such a document, few understand the scope of information that is needed to run a successful department. This is especially important for those organizations subject to the strictures of S-Ox.

The procedures manual can also be used to determine whether any processes can be eliminated. Needless to say, this document will not be the most interesting book ever written, but it is essential. As an added benefit, it will make the auditors happy.

The manual should not only be prepared by those who are actually doing the day-to-day tasks, but it should also be updated regularly. Some choose to do this anytime a process is amended or added, whereas others do it annually. It is imperative that this be done. You'd be surprised to discover just how much processes change over the course of a year.

There is one other reason to have this manual and insist that everyone follow it. Left to their own devices, processors in accounts payable will gradually develop their own procedures. Without a careful and periodic review, each person will end up handling transactions differently. There is a word for this, and it is *chaos*. If one processor has an idea for an improved way of doing a particular task, the suggestion should be raised with the manager. If it is determined that the suggestion is superior to the methodology in use, everyone should change how they handle that particular task, and the policy and procedures manual should be updated to reflect this change.

Now, if this seems to be a cumbersome and costly task, think again. Thanks to the Internet, many companies now post their manuals on their corporate intranet site. This makes it available to anyone who may need to check it. It also makes updating a snap, and there are no costly printing charges each time the manual is updated. Finally, putting all the latest changes on the intranet removes that old chestnut of an excuse: "nobody told me." E-mail alerts can be sent to everyone who is affected each time the policy is updated.

If your accounts payable department does not have a policy and procedures manual, the staff should bite the bullet and prepare one. If topics are divided among the staff and each one writes a chapter or two, the work will not seem overly burdensome.

If you need some samples, do a search on the Internet. You'll come up with numerous samples that you can modify to fit your own procedures. One word of caution regarding those Internet policies, however: Most are written by universities. If you are in a manufacturing environment, you may have to add several sections. Still, having something to start with is a big help.

Finally, once the manual is completed, especially if it includes your T&E procedures, all affected parties should be notified that they will be expected to conform to the policies. Expect a certain amount of complaining. To make sure the policy is enforced, the first notice to the staff should come from a high-level executive (e.g., the controller or the CFO). Some companies put a short note from this executive on the front page of the policy so everyone understands that they will be expected to adhere to it. This is especially important when it comes to issues like T&E, Rush checks, and not returning checks to requisitioners.

BAD CONTROL PRACTICES

- Not closing purchase orders when payments are made via wire transfers

- Allowing purchase orders to be partially filled out
- Not employing appropriate segregation of duties
- Lack of appropriate oversight and controls over spreadsheet applications
- Allowing a poor working relationship between accounts payable and purchasing to fester

RECOMMENDED MANAGEMENT ACTIONS

- Take Section 404 of S-Ox seriously, even if you are not required to.
- Insist on proper flow of information to accounts payable from all parties.
- Establish a protocol regarding where invoices are sent.
- Update your accounts payable policy and procedures manual regularly.