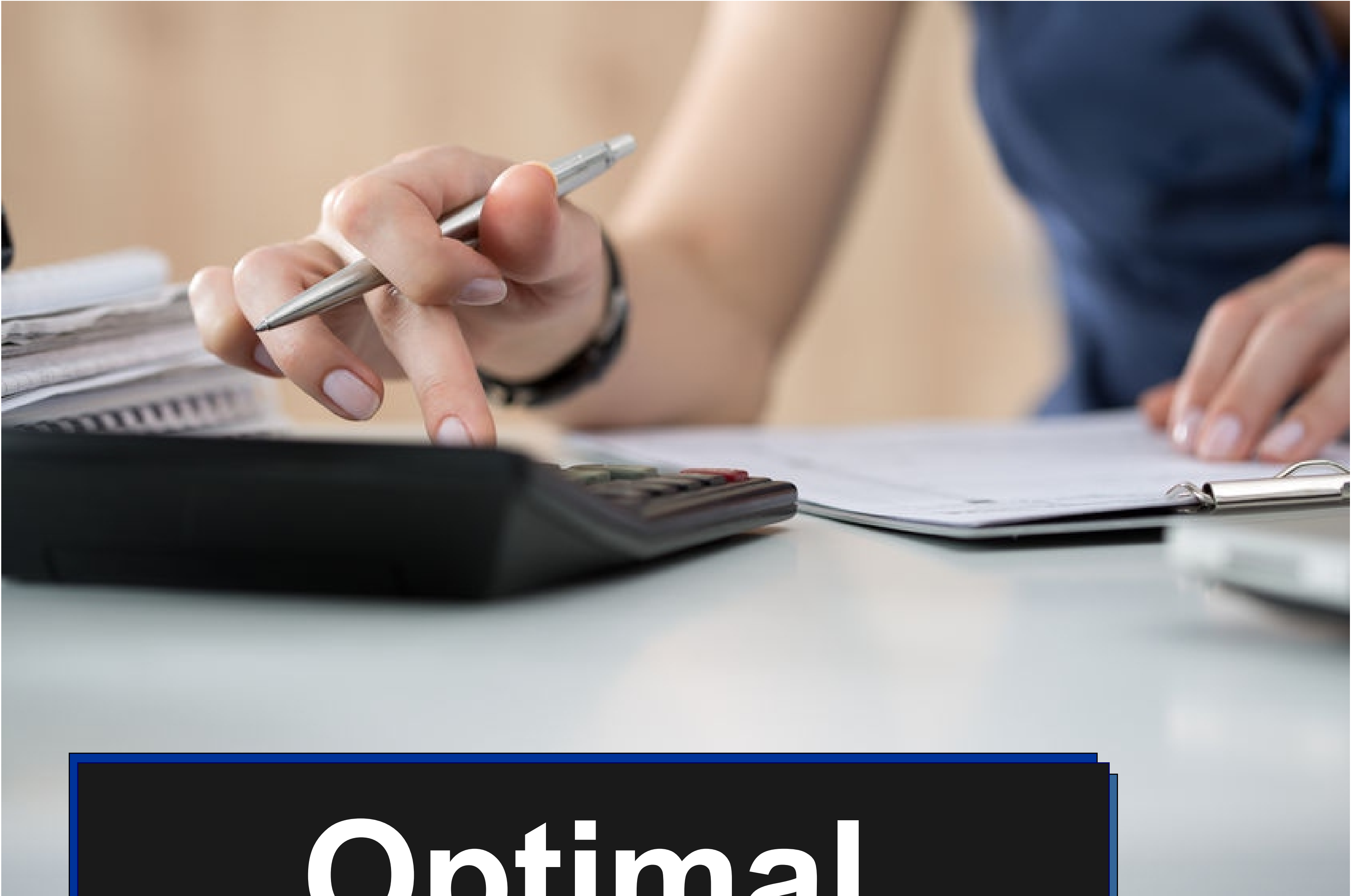

Optimal Accounting for Payables

CPE Edition

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Optimal Accounting for Payables

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Course Information

Course Title: Optimal Accounting for Payables

Learning Objectives:

- State the reasons why a payables system needs to make prompt payments.
- Identify the issues associated with a three-way matching system, and how they can be corrected.
- Recognize the alternatives available for reducing the amount of payables data entry.
- Recognize the advantages and disadvantages of a reverse lockbox system.
- Describe the problems associated with the production of manual checks.

Subject Area: Accounting

Prerequisites: None

Program Level: Overview

Program Content: The recordation and payment of accounts payable is a deeply inefficient process. *Optimal Accounting for Payables* shows how to enhance the basic process, as well as how to sidestep portions of it entirely. The result is a much more efficient and effective payables function. The course also notes the impact of these changes on closing the books, fraud, and the annual audit.

Advance Preparation: None

Course Expiration Date: This course expires one year from the date of purchase.

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Optimal Accounting for Payables

Introduction

The accounting for payables can be remarkably inefficient, for several reasons. First, the process flow can cause unpardonable payment delays. And second, there tend to be *a lot* of controls, to keep inappropriate payments from being made. Unfortunately, these controls make it much more inefficient to pay suppliers. Since the payables process is so inefficient, it makes sense to explore ways to optimize the situation – which is what we do in this course. The emphasis is not on having the most exquisitely refined payables system on the planet, but rather on having an efficient one that incorporates the latest best practices.

Related Podcast Episodes: Episodes 13, 35, 36, 81, 82, 138, and 247 of the Accounting Best Practices Podcast discuss accounts payable controls, recovery auditing, the universal payment identification code, best practices, payables matching, lean systems, and payables fraud schemes. The episodes are available at:

accountingtools.com/podcasts or **iTunes**

Payables Inefficiencies

Before we get into optimization solutions, it can be worthwhile to briefly cover the extent of the inefficiencies related to payables. Let's start with a supplier invoice that is mailed to the company. The invoice probably goes straight to the payables department, which sends it out to the responsible manager for approval. This approval requirement is a common feature in many companies, under the logic that if an invoice is going to be charged to a manager's departmental budget, the manager should approve the invoice first. This seems fine, but what if the manager is busy? The invoice goes straight into his "in" box, and that is where it stays, as other paperwork arrives and gets dumped on top of it.

Eventually, the supplier finds that it has not been paid on time, so it sends a duplicate invoice, along with a demand for immediate payment. This causes consternation in the payables department, since there is no record of the invoice. So, someone walks the invoice to the appropriate manager, and waits while she signs off on it. Then the messenger walks the invoice back to the accounting department, where it is logged into the system, and an emergency check run is processed, in order to pay the supplier right away. And on top of that, the manager who was supposed to sign off on the supplier invoice the first time around eventually finds the original invoice in her "in" box, signs off on it, and sends it in. This means that the payables staff has to figure out if this is a duplicate invoice, which requires some extra research work. So, those are a few issues with invoices that need to be approved upon receipt.

Another category of payable is for a supplier invoice that has been authorized in advance with a purchase order, which is issued by the purchasing department. In this case, the accounting staff is supposed to engage in three-way matching, which means that someone has to compare each invoice to the authorizing purchase order and receiving documentation, to prove that the invoice has been authorized and the purchased item has been received. If either one of these documents is missing, the supplier invoice sits, while the payables staff tries to find the missing information. This situation can be wildly inefficient, with the payables clerk scrounging through purchase orders in the purchasing department and pleading with the warehouse for receiving records. The situation is even worse if the invoiced price turns out to be different from the price stated on the purchase order, or the amount received differs from the authorized amount –

then the payables staff has to discuss the issue with the purchasing staff to decide how much to pay the supplier.

Another issue with payables is the processing of employee expense reports. Employees sometimes pay for company-related expenses themselves, especially when traveling, and they need to be reimbursed fairly quickly. There is a risk that employees are spending an excessive amount, such as paying for first class airfare instead of economy. To combat this, the typical organization requires a detailed review of every expense report, matching the reimbursement amounts on the report to the supporting receipts – and making sure that the expenditures were in accordance with the official corporate travel policy. When there are a lot of employees, this auditing process can take an extraordinary amount of time - which not only interferes with other accounting work, but also delays the prompt payment of employees. That last point is critical, since employees need to be reimbursed so that they can pay their credit card bills. In short, expense reports seem to cause much more grief for the payables staff than the amount of expense that is under review.

Another problem with payables is simply entering the invoices into the company's payables software. This is time-consuming, and it is quite possible that the payables clerk will make a keystroke error, entering the wrong supplier name, invoice number, payment amount, and so forth. This can be a major problem when a supplier is invoicing from multiple locations, or when an invoice contains a lot of line items, each of which has to be coded to a different account.

And then there is the payment process, which is not known for its efficiency. The payables clerk has to unlock the storage cabinet where check stock is kept, which means going to the controller and asking for the key. Then the check stock is used to print checks, after which the clerk verifies that the payments were made correctly, and then returns the unused checks to the storage locker and logs in the range of check numbers that were used. These security steps are needed to make sure that no one can make off with any unused checks. But they also slow down the process. Then the clerk assembles the supplier invoices and other supporting documentation for each check, clips them to the checks, and makes an appointment with an authorized check signer to sign the checks. The clerk then sits with the check signer, while this person examines the supporting documentation for each check and decides whether to sign the check, reject it, or ask for more detail. Assuming that the clerk gets everything signed, the next steps are to tear away a copy of the remittance advice from each check, staple it to the supporting documentation, and file away everything in the accounting records. As you can see from the many steps involved, paying suppliers is not a wildly efficient process.

Optimal Accounting for Invoice Approvals

One of the key inefficiencies in payables is gaining invoice approvals from managers. To some degree, an approval process is necessary, since it keeps improper purchases or fraudulent invoices from being paid. However, this does not mean that every invoice needs an approval. There are several ways to enhance the situation. First, use negative approvals. This means that the payables staff logs every invoice into the accounting system as soon as it is received, without waiting for a manager approval. An invoice copy then goes out to the relevant managers, telling them that the invoice will be paid unless they say otherwise. Thus, they only have to respond if they do not agree with a supplier payment, which will likely be a very small proportion of the time.

Another way to avoid the use of approvals is to adopt a cutoff value, below which no approvals are required at all. For example, all invoices totaling less than $100 will be paid automatically. This approach can be quite effective, since the majority of all supplier invoices tend to be quite small. However, there is a risk – an outsider might figure out that small invoices are being paid automatically, and so will send in a recurring invoice that is priced just below the threshold level. This risk can be minimized by conducting an occasional review of small invoices, to see if any invoices look suspicious.

Yet another way to avoid approvals is to increase the use of a company credit card. A few trusted employees can be given a company credit card, which they can use for certain kinds of purchases, up to a certain limit. For example, the executive assistant in the engineering department could use a credit card to make incidental purchases of up to $500, with a monthly cap of $10,000. The result is that the payables department receives just a single monthly statement from the credit card company, which could replace hundreds of supplier invoices. Admittedly, processing that credit card statement can be fairly complex, but doing so is still much easier that dealing with the many invoices that it replaces. Here again, the option is not perfect, because there is a risk of abuse. A credit card user could pay for unneeded items, which may not be discovered for quite a while, especially if these purchases are small. Nonetheless, these options can eliminate a large part of the burden of obtaining invoice approvals.

Optimal Accounting for Three-Way Matching

Three-way matching is inherently inefficient, because the accountant is being asked to reconcile information that is coming from three different sources – the invoice comes from the supplier, the purchase order comes from the purchasing department, and receiving documentation comes from the receiving department. Given the wide variety of sources, it would be a small miracle if all of this information were to exactly agree with every other item. Consequently, it makes sense to adopt some practical rules for dealing with variances. First, the unit count billed by the supplier may differ from the amount authorized by the purchase order. If the amount bill is less than the authorized amount, then pay the amount billed by the supplier. Second, if the amount billed is more than the authorized amount and this amount is verified by the receiving documentation, then pay the amount billed by the supplier – up to a predetermined limit, such as a five percent overage. Above that amount, notify the purchasing department, which might want to have a chat with the supplier about sending too many units to the company. And third, if the supplier billed a higher unit cost than what was authorized by the purchase order, pay the amount stated on the purchase order, and let the purchasing department work through the difference with the supplier. These rules can certainly be adjusted, but the main point is to give the payables staff some decision-making authority, so that they can resolve three-way matching variances on the spot and process a payment, rather than waiting for someone else to tell them what to do.

A variation on the use of rules is to avoid three-way matching entirely if the dollar amounts involved are below some threshold value. For example, if a supplier invoice is for less than $1,000, the payables staff accepts the invoice without further investigation, or it only conducts part of the matching, such as just checking for proof of receipt. The exact rule will vary by company, depending on an analysis of the size of invoices received and management's comfort with not conducting an examination of every invoice received.

After conducting a fair amount of three-way matching, a payables clerk will probably be able to state with quite a bit of confidence that only a small number of suppliers cause all of the matching exceptions. They either have sloppy systems or do not follow the company's billing and shipping rules, and so are constantly causing grief for the payables staff. It can be worthwhile to keep track of these variances and bring them up with the offending suppliers. When this continues to be a problem, the payables manager can mention the issue with the purchasing manager, with a suggestion to find a different supplier.

The preceding solution was a simple rules-based one, which can be implemented anywhere. However, there are other options available that can reduce the payables workload further, but which require an investment in software. One option is to give the receiving department access to all open purchase orders, right at the receiving dock. When a supplier delivery comes in, they call up the open purchase orders for that supplier on a computer terminal, and enter the number of units received. The system could even go a step further and schedule payments to the supplier without the supplier having to deliver an invoice at all. Instead, the system just multiplies the unit price stated in the purchase order by the number of units received to arrive at a payment amount.

Another option is to automate the three-way matching process. A special software module is available on high-end accounting software systems that conducts the entire matching process automatically, and then flags any anomalies for further review. This approach only works when the receiving department enters all receipts into the software, purchase orders are entered into the same system, and the payables staff enters every line item on every invoice received. That last point is worth a bit more discussion. The normal invoice data entry process only involves entering the grand total on an invoice into the accounting software, unless there are line items on the invoice that need to be charged to different expense or asset accounts. But when an automated three-way matching system is used, the software needs to see every line item on every invoice, so that it can compare each one to what the receiving department reported as having been received, and to every purchase order line item. This means that there is a trade-off between entering more invoice information and not having to do three-way matching.

The most elegant way to avoid three-way matching, and a large part of all payables activities, is the evaluated receipts system. Under this approach, a supplier is totally integrated into the company's production system, so that it sends components to the company's assembly line as needed. Once finished goods are produced by the company, the software calculates the number of components that must have been included in each finished unit, multiplies that amount by the authorized component price as stated in the related purchase order, and sends a payment to the supplier. This approach sounds wonderful, since the entire payment process is automated. However, the company needs to perfect several issues before it can implement evaluated receipts. First, it can only have one supplier for each component; otherwise, it will be too difficult to figure out whether the component used in a product came from Supplier A, B, or C. Second, scrap levels need to be extremely low – preferably very close to zero. Otherwise, suppliers will complain that they shipped more components than they were paid for, since some of them were scrapped. Achieving a zero scrap rate requires a great deal of attention to proper product design and quality. A third issue is that the bill of materials has to be perfect for every product. The bill of materials identifies every component in a product, along with the number of units of each component that is used. Getting these issues right is no small feat, which is why very few companies use evaluated receipts, even though it is an obvious improvement over the traditional payables system.

A potential problem with evaluated receipts is that it does not necessarily apply to all sources of invoices that a business may receive. It is primarily targeted at purchases being made for production activities, which means that other invoices related to general and administrative activities will still be received. For example, there may be ongoing invoices related to rent, utilities, legal fees, and office supplies. This means that the traditional payables system must still be retained to process these invoices, though the amount of invoice volume running through it should decline dramatically.

Out of these options, the simplest approach is to apply a few rules to minimize the amount of three-way matching, as well as the criteria for what constitutes an exception. Of the computerized solutions, giving the receiving staff online access to open purchase orders at the receiving dock makes a lot of sense, since this eliminates the need to send any receiving documentation to the payables department. We cannot recommend automated three-way matching in many situations, because it just automates what is essentially an inefficient process, without trying to improve the underlying process. The best theoretical solution is an evaluated receipts system, but it only applies to a small number of well-organized businesses.

Optimal Accounting for Expense Reports

There are lots of ways to improve upon the expense reporting process. One option is to use corporate credit cards, so that most expenses are paid for directly by the company. A somewhat similar option is to set up an in-house travel agency (or work with an outside agency) that handles all air and hotel billings, so that the company directly pays for these expenses, too. These two steps will cover an enormous chunk of the total amount of expenses for which employees are reimbursed, making the residual amount much less of an issue.

Another possibility is to pay all expense reports without review, but to conduct an ongoing random audit of selected expense reports. The assumption here is that nearly all employees are honest, so it is a waste of time to examine most expense reports – there will not be anything to find. Instead, the intent is to spot the occasional expense report where there is an actual problem, and then flag the offending employee's prior expense reports for a thorough review, while also flagging all future expense report submissions by that individual for the same level of detailed examination. This is an intelligent way to balance the amount of examination work by the payables staff against the amount of cost savings they can generate.

A more technologically advanced solution is to contract with an outside provider of an on-line expense reporting system to process the company's expense reports. Employees log into the site and are asked to enter the dates and amounts of expenditures, and also attached scanned images of their receipts (or are given the option to mail them in). The company's travel policy has already been loaded into the system, so the software can compare the employee submissions to what is allowed by the travel policy, resulting in automatic acceptances or rejections by the system. As a byproduct of this process, the system creates an online expense report that is routed to the supervisors of those submitting expense reports, to gain their approval for payment. The expense report file can be interfaced with the company's payables system, so that payments can then be processed through the standard system.

Optimal Accounting for Data Entry

In most organizations, there is no getting around the need to manually enter a supplier invoice into the accounting system. However, there are some basic workarounds that can greatly reduce the volume of invoices received. As already mentioned, the company can pay for small purchases with a company credit card, so that many small invoices are replaced by one large credit card statement per month. Another option is to compress the number of suppliers. For example, the purchasing department can restrict the purchase of office supplies to a single distributor. Using fewer suppliers makes sense from a purchasing perspective, too, since the company can increase its total spend with each supplier, qualifying it for volume discounts. When purchases are focused in this manner, the total number of invoices received will likely go down.

Another option that is available on some of the higher-end accounting software packages is a Web page that suppliers can use to enter their own invoices into the company's accounting system. This has multiple advantages. First, suppliers are less likely to enter incorrect information, since they do not want an error to delay the payments being made to them. Second, the data entry task is entirely shifted to the suppliers. And third, the same system can be used to give suppliers information about when their invoices are scheduled for payment, so they no longer have to call the payables department to ask for this information. Despite these advantages, having suppliers enter their own invoices can require some resources. Even though the payables staff no longer has to do data entry, it does need to oversee the data entry of the suppliers – which means issuing them access codes to the system, giving them training as needed, answering their questions, and monitoring the system for mistakes. Also, suppliers are less likely to want to enter their own invoices unless the company is a large customer. When this is not the case, they may decide to just send in an invoice and let the payables staff worry about the data entry.

Optimal Accounting for Payments

The basic method of payment for suppliers for a long time has been the check. The controls needed to make sure that checks are processed correctly make this an inherently inefficient process. We have two solutions, one of which is quite radical, and the other more modest. We will cover the radical approach first, since it also provides a solution to the data entry for supplier invoices, which we just covered. This option is called the reverse lockbox. Under this arrangement, suppliers are told to send their invoices to the company's bank, which digitizes the invoices and then forwards the images to the payables department through an online interface. The payables staff then flags the approval status of each invoice and sends this information back to the bank. The bank then pays these invoices on their due dates, and sends an online notification back to the company that the invoices have been paid.

The bank can take on some of the payment approval process by working through a set of automated decision rules, such as paying all invoices below a certain threshold amount, and all invoices from a list of pre-approved suppliers. That way, the payables staff can minimize its involvement in the payment process.

This approach has some additional benefits. First, there are no checks on the premises, so the controls related to making payments are not needed. And second, the bank can offer suppliers an early payment discount, where it pays them early in exchange for paying them a slightly reduced amount. This can really help those suppliers who need quicker payments.

The downside is that only a few of the largest banks offer this service, and they will not offer it unless the company is large enough to be worth setting up interfaces between the bank's scanning and payment systems and the company's payables system. So, this option is only available for larger companies.

The more modest improvement is to switch away from checks and use ACH payments instead. ACH is short for Automated Clearing House, and involves sending batches of electronic payments straight into the bank accounts of suppliers. ACH payments can either be set up through a higher-end accounting system and then routed through a bank, or the payables staff can set up these payments through the company's bank's website. The cost of these transactions is only a few cents per payment, so it is definitely less expensive than the cost of check stock, an envelope, and a stamp, not to mention the bank fee for processing a check. This is also a more efficient approach than paying by check, since payments will arrive in supplier bank accounts a lot more quickly than when they are sent by mail.

There are a few ways to accelerate the rollout of ACH. For example, ACH payments could be used as a negotiating point when discussing terms with suppliers. Or, include ACH signup information in the welcome packet sent to new suppliers. Another option is to offer to pay slightly faster when suppliers accept ACH terms. One way to offer faster payment terms is to schedule ACH payments more frequently than check runs. In short, keep the issue in front of suppliers, and make the conversion attractive to them.

The main problem with ACH payments is that only a limited amount of information can be sent along with each payment, so the supplier may not have enough detail to figure out which invoices are being paid. This is a real problem when the company is paying for several invoices at once, and especially when it is subtracting some credits from the billed amounts, which makes it nearly impossible for the supplier to infer what is being paid. The solution is to send a separate e-mail to the suppliers being paid, which contains the complete detail for what is being paid by ACH.

So to summarize, a reverse lockbox is quite a nifty arrangement, but is only available to larger organizations. Conversely, ACH payments can be made by anyone, since nearly all banks offer some sort of online access to an ACH payment page. So, electronic payments should certainly be a reasonable alternative to check payments.

Miscellaneous Improvements

There are lots of small ways to improve payables that we have not yet covered. One item to look for is when invoices have been mailed by suppliers to people or departments within the company other than accounts payable. When this happens, there is a good chance that the invoices will be delayed in someone's "in" box before they are eventually forwarded to the payables department. To keep this from happening, look at the mail-to address on all received invoices to see if they were sent to someone else in the company, or make note of invoices that arrive from elsewhere in the company. Then contact these suppliers and request that future invoices be sent straight to the payables department. Another way to do this is to send a welcome packet to all new suppliers, in which it is made quite clear that all invoices should be sent to the payables department.

Another way to improve payables is to adopt a set of rules related to the approval of invoices. We have already noted the use of negative approvals, but there are other ways to fine-tune the process. For example, if a purchase order has been used to authorize a purchase, then no additional approval is ever needed, no matter how large the invoiced amount may be. This is because someone already had to approve the purchase order. Another approach is to issue an automatic approval based on the billing history of the supplier. So, if a supplier has an excellent record of issuing flawless invoices with a perfect record of having shipped in the correct quantities and billed at the right prices, then there is no need for an approval. Though if this approach is used, an occasional audit might be worthwhile.

Another approach is to use a backup approver. This person is used when the primary approver is not available, and an invoice absolutely has to be approved. If a backup approver is used, make sure that the person is sufficiently knowledgeable to have an understanding of what is being requested. This usually means that the number two person in a department is designated as the backup approver.

Another area to think about is disputes over invoiced amounts. There may be problems with the sales tax being charged, or the billed unit price, or the number of units received, or whether a credit will be issued. Arguing over these issues can take up *a lot* of staff time, which is not efficient. And if these arguments result in payment delays, suppliers may cut back on the amount of trade credit granted, which can cause financing issues. To minimize these issues, it can make sense to maintain a log of all open payables disputes and review it every day, to make sure that no issues are left hanging. It can also be useful to develop a protocol for the different resolution options, and allow the payables staff a broad level of authority to settle most disputes. For example, a payables clerk can approve any supplier billing variances of up to $50, after which the issue is shifted up to the payables manager. By taking these steps, the really major problems are brought to the attention of management, while small issues are settled on the spot.

A fairly large annoyance for the payables staff is manual checks. Someone outside of the department may decide that a rush payment is needed, where a check has to be issued today. This is not efficient, since it falls outside of the normal processing of payments in batches, which usually occurs once or twice a week. Instead, a payables person has to manually create the check, find a check signer, and log the payment into the payables system. There is also a good chance that the person writing the check will forget to log the check into the system, which will not be detected until the next bank reconciliation. There are several ways to reduce the number of manual check requests. For example, the accounting department could charge a large fee to the department requesting the check. Another option is to follow up with the requesting department to see if a process can be developed in the future to avoid these situations. Yet another possibility is to increase the frequency of scheduled check runs, so that more manual check requests can be scheduled into a regular check run.

Yet another issue is requests to hand-deliver checks. When someone wants a special delivery of a check, the payables clerk has to rummage through the latest check run, extract the check, and walk it over to the person who made the request. Or, the request may be to use an overnight delivery service to deliver the check. In either case, this is a major divergence from the normal routine, which makes check processing much less efficient. To reduce this problem, either have these check requesters make their request through the company controller, or charge them an inter-departmental fee to make the special delivery. In short, a crisis caused by the bad planning of someone else should not have to impact the payables department.

And on the topic of special requests, what about cash advances? An employee requests an advance, perhaps to pay for travel expenses. The payables staff then has to make a special accounting entry to record this advance as an asset, and then needs to monitor the employee's subsequent expense reports to make sure that the expense reports are offset against the amount of the advance. It makes much more sense to use company credit cards to make purchases, thereby avoiding the need for employee advances. Also, consider having a company policy that employee advances will not be granted without senior management approval.

Improving the payables function is not just about streamlining processes. It can also involve saving money on the amounts paid to suppliers. For example, suppliers may occasionally issue credits to the company for various reasons, such as for returns or sales allowances – but forget to send a copy of these credits to the company. A good way to detect these credits is to request a quarterly or semi-annual statement of account, at least from the larger suppliers, and review the report for open credits. These credits can then be used to offset other payments.

A final thought on miscellaneous improvements is to conduct a periodic cleanup of the aged accounts payable aging report. This report categorizes payables to suppliers based on 30-day time buckets. The report is used as a visual aid for figuring out which invoices are due for payment. The trouble is that it tends to become cluttered with stray debits and credits, which makes it less useful. Consider cleaning up the report on a regular basis, writing off debit balances that will not be paid and scheduling credits for use as soon as possible.

No single item among these miscellaneous improvement recommendations will make an overwhelming difference in the efficiency of the payables department. Instead, consider the pursuit of an improved payables function to be a series of small, incremental changes. If the commitment is made to enact every possible upgrade, the result will eventually be a noticeable uptick in departmental efficiency.

What Not to Do

The payables process is a well-defined series of steps, with controls built into it at several points along the way. The accountant might be tempted to simply strip out a few steps in order to make the process more efficient, such as not locking up checks, not logging the range of check numbers used, and not attaching supporting documentation to the checks being sent to a check signer. Doing so always weakens the controls of the payables system, which increases the risk of losses, either through simple mistakes or from fraud.

It can be instructive to view the payables function from the perspective of a large publicly-held company. The controller of this organization knows that the company will be skewered by its auditors if there are any weaknesses in its system of controls. Instead, the payables department first figures out the most streamlined way to process payables transactions in a highly automated manner, and then imposes highly targeted controls over any areas in which there might otherwise be a control weakness. For example, a large company might use a reverse lockbox to shift payables processing mostly off the premises, which completely alters its need for controls. So, whenever you are thinking about cutting back on payables controls, think about what the accountants in a large company would do in the same situation. They would revise the underlying system and make sure that the controls were strong.

Monitoring of Optimal Systems

When working towards an optimal payables system, the main focus is on the acceptance rate for new methods of processing invoices and paying suppliers. For example, a business might track the overall percentage of invoices being directly entered into the system by suppliers. This metric could be used to concentrate business with those suppliers more willing to enter their own invoices into the system. Another monitoring technique is to measure the percentage of electronic payments being made, as opposed to check payments. A variation on the concept is to measure the number of manual check requests received every month, and especially *who* is making the requests. This information can be used to bear down on those suppliers or employees who are unwilling to switch to more regimented, electronic payments. Yet another possibility is to track the number of invoices that still require a three-way match. This number should be fairly low, after a company implements alternative arrangements such as company credit cards and evaluated receipts. The payables team could periodically look at the characteristics of each invoice still requiring a three-way match, to see if the departmental processing rules can be altered to reduce the number of these invoices.

The point behind these measurements is to focus on departmental improvements. As the staff gradually enhances departmental performance by transitioning to new procedures and systems, it is quite possible that these measurements will no longer be needed.

Impact of Optimization on Closing the Books

A few of the changes noted here can improve the speed with which the financial statements can be issued at the end of each month. Having suppliers enter their own invoices through a website and using negative approvals means that invoices are recorded in the system faster, so the controller does not need to keep the books open for very long to ensure that all invoices have been received.

Impact of Optimization on Fraud

The optimization of payables can have varying effects on the risk of fraud, with some risks increasing and others declining. For example, when a business increases the use of company credit cards, there is an increased risk that the cards will be misused. Also, when rules are used to restrict the amount of three-way matching, this opens the door for supplier fraud in the areas that are no longer covered. However, the use of rules typically means that only small supplier invoices are not being reviewed, so the aggregate dollar amount of fraud that might result should be relatively low. If a business decides to use a reverse lockbox arrangement with a bank, this can have a positive effect on fraud levels, since the bank is making payments on behalf of the company, which removes the need for any payments being made directly by the business. With no checks on the premises, there is no way for anyone to steal or alter checks.

Overall, the optimization suggestions we have made will result in a slight increase in the risk of low-level fraud.

Impact of Optimization on the Annual Audit

The recommendations noted in this course will not have a dramatic impact on the work of the company's auditors. Some existing systems may be used less, but will probably not be replaced entirely. For example, an evaluated receipts system will reduce the flow of invoices through the pre-existing payables system, but will not replace it. New systems may be added that are handled by outside services, such as a reverse lockbox arrangement with a bank. If so, the auditors may want to obtain assurances regarding the control systems being used by those entities, which could increase the amount of audit staff time by a modest amount.

Summary

The traditional payment process is not efficient, since it requires the use of authorizations and cross-checking against receiving documents to ensure that each individual payment should be made. In this course, we have introduced an array of sensible adjustments to the process in order to streamline it, as well as several entirely new concepts that can completely replace large parts of a traditional payables system. For example, the use of corporate credit cards, negative approvals, automatic approvals for invoice amounts below threshold levels, and restrictions on the use of manual checks can dramatically improve the efficiency of the existing process. Or, a business can switch to a reverse lockbox system to eliminate payment processing, or install an evaluated receipts system to eliminate the need for supplier invoices. These latter improvements are usually only available to larger businesses, but the many smaller suggestions noted here can be installed by organizations of all sizes, usually at minimal cost.

Review Questions

1. The following documents are needed for a three-way match, except for:
    a. The purchase order
    b. The expense report
    c. The supplier invoice
    d. Receiving documentation

2. An evaluated receipts system will only operate correctly in the following environment:
    a. Where scrap levels are very low
    b. Where only one product line is being manufactured
    c. Where multiple suppliers are used for each component, to save costs
    d. Where bills of material have been created for most major products

3. The essential item *not* to do when optimizing a payables system is to:
    a. Cut back on staff
    b. Work with auditors to develop the changes
    c. Reduce the number of controls
    d. Coordinate the changes with other departments

Answers to Review Questions

1. The following documents are needed for a three-way match, except for:
   a. The purchase order
   b. The expense report
   c. The supplier invoice
   d. Receiving documentation

   a. Incorrect. A purchase order is needed to ensure that the price stated on a supplier invoice has been properly authorized.
   b. **Correct. An expense report is not connected to the three-way matching process. It is verified by reviewing the attached receipts provided by the submitting employee.**
   c. Incorrect. The supplier invoice is the baseline document being verified in a three-way match.
   d. Incorrect. Receiving documentation is needed to verify that the unit quantity being billed on the supplier invoice is accurate.

2. An evaluated receipts system will only operate correctly in the following environment:
   a. Where scrap levels are very low
   b. Where only one product line is being manufactured
   c. Where multiple suppliers are used for each component, to save costs
   d. Where bills of material have been created for most major products

   a. **Correct. When scrap levels are very low, all deliveries made to a company's production line should make it through to finished goods, making it easier to calculate the amount to pay suppliers.**
   b. Incorrect. An evaluated receipts system will function properly in an environment in which many products from multiple product lines are being produced.
   c. Incorrect. Purchases should be sole sourced, making it easier to determine who provided the components inserted into finished goods.
   d. Incorrect. A bill of materials must have been created for all products, and they must be extremely accurate. These files are needed to calculate the amount of components used in finished goods, and are the basis for payments to suppliers.

3. The essential item *not* to do when optimizing a payables system is to:
   a. Cut back on staff
   b. Work with auditors to develop the changes
   c. Reduce the number of controls
   d. Coordinate the changes with other departments

   a. Incorrect. A possible outcome of an optimized system is a reduction in headcount; it depends on the reduction in staff time caused by the implemented changes.
   b. Incorrect. Auditors can provide valuable advice about structuring controls to match the changes that have been made.
   c. **Correct. Controls should be kept as strong as possible wherever there are perceived weaknesses in the payables system.**
   d. Incorrect. Many payables enhancements are entirely internal to the payables department and will never be noticed by anyone else. However, a few, such as an evaluated receipts system, are closely linked to the activities of other departments, such as engineering and purchasing, and so require their complete cooperation.

Glossary

A

Accounts payable. Short-term obligations to pay suppliers for products or services purchased on credit.

Automated Clearing House. An electronic payment system that is designed for high volume, low-value payments.

B

Bill of materials. A record of the raw materials and sub-assemblies used to construct a product.

C

Check. An authorization to draw funds from a bank account.

E

Expense report. A form completed by employees to itemize the expenditures for which they are requesting reimbursement.

I

Invoice. A document submitted to a customer, identifying a transaction for which the customer owes payment to the issuer.

N

Negative approval. When the approval of a transaction is assumed, unless the authorizing person states otherwise.

P

Purchase order. A written authorization from a buyer to acquire goods or services.

R

Remittance advice. A statement that accompanies a payment, detailing what was paid.

Reverse lockbox. When suppliers are instructed to send their invoices to the company's bank, which digitizes the invoices and forwards them to the company's accounts payable system through an online interface.

T

Three-way matching. The process of comparing a supplier invoice to the authorizing purchase order and related receiving documentation, prior to authorizing payment.

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Final Examination

The final examination for this course is provided below. Feel free to circle your choice for the best answer to each question. To enter your answers online and receive an immediate grade and completion certificate, follow these steps:

1. Go to www.accountingtools.com/cpe
2. Click on the "Access the Training Module | Complete a Test" button near the top of the page.
3. Login with your user name and password.
4. Select the **Take a Test** option and then select the **Programs** option. Click on the program that you want to take.
5. Take the test. You can stop and restart the test at any time.

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1. It is essential that employees be reimbursed for the amounts stated on their expense reports, because:
    a. A three-day limit on payment delays is the maximum allowed by law
    b. It is required in order to flush out the liability from the books by the end of the month
    c. Employees need to pay their credit card bills
    d. These reimbursements should coincide with the payment of paychecks

2. Three-way matching is inherently inefficient, because:
    a. The information being reconciled comes from three different sources
    b. It involves every invoice related to general and administrative expenses
    c. It is required for all services billings from suppliers
    d. All exceptions must be bumped up to the controller for resolution

3. One way to reduce the amount of payables data entry is to:
    a. Record individual line items on supplier invoices
    b. Restrict the use of company credit cards
    c. Expand the number of suppliers used
    d. Have suppliers enter their own invoices into the organization's payables system

4. A valid downside of a reverse lockbox arrangement is that:
    a. Only a few of the largest banks offer this solution
    b. This solution is applicable only to smaller firms
    c. It is no longer possible to offer early payment discounts to suppliers
    d. It is mostly designed for companies with large headcounts

5. When a manual check is prepared, there is a good chance that the payables person preparing the check will forget to:
    a. Deliver the check
    b. Use the correct check stock
    c. Log the check into the payables system
    d. Delete the check from the next scheduled check run