

Best practices
for accounts
payable
management*

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About Global Best Practices®

The PricewaterhouseCoopers' Global Best Practices team researches and writes about leading business practices in today's global marketplace. Best practices are the means by which leading companies have achieved top performance, and they serve as goals for other companies striving for excellence. Best practices are not the definitive answer to a business problem but should serve as a source of creative insight for business process improvement.

Overview

In recent years, accounts payable (A/P) operations have automated and streamlined their processes. New technology, such as electronic invoice presentment and payment (EIPP) and electronic funds transfer (EFT), has enabled automation of many A/P transactions. Businesses also have recognized that A/P professionals can play a strategic role in advancing a company's financial goals if they shift focus from transaction-oriented processes to value-adding activities.

Leading companies use a variety of EFT tools to make payments electronically and rely on computer-assisted audit techniques (CAAT) and other technology-based antifraud procedures to monitor and stop illegal A/P transactions. Many companies also seek to streamline or eliminate steps in A/P transactions, such as invoice processing.

Despite this push toward automation, companies still strive to maintain a strong relationship-based focus. They seek progressive approaches to supplier communications, payment timing, and fraud prevention. They also leverage other organizational initiatives, such as regulatory compliance and internal control efforts, to achieve better A/P efficiency.

This paper is one in a series that focuses on key best practices for improving financial effectiveness. The following sections illustrate best practice approaches to A/P management.

A. Manage payment timing and terms to maximize cash flow.

Leading companies proactively manage the A/P process to support cashflow objectives. The goal is to achieve neutral or positive cash flow by making sure that cash is paid out at a rate equal to or slower than the rate at which cash is collected.

To find out how fast the A/P department pays its bills, leading companies monitor specific performance measures, such as:

- Days payable outstanding—Annual A/P, divided by annual cost of goods sold, and then multiplied by 360 days. For example, a company with annual A/P of \$100,000 and annual cost of goods sold of \$1,400,000 would have 25.71 days payable outstanding.
- A/P turnover — Annual cost of goods sold divided by annual A/P. A company with \$1,400,000 annual cost of goods sold and \$100,000 annual A/P would have an A/P turnover ratio of 14.

With this information, a company may then set performance targets to support its cash-flow objective—specifically, to pay out cash at a rate no faster than it receives cash. For example, a company may decide to make all payments 30 days from the invoice date, or negotiate with suppliers for the most lenient payment terms that fall within the targeted time period.

Finance managers also take advantage of prompt-payment discounts whenever appropriate. Although many suppliers are moving away from the practice, some continue to offer prompt-payment discounts to discourage customers from deferring payments. These suppliers volunteer to reduce the total amount of the bill, usually by a predetermined percentage, for companies that agree to pay on or before the due date. As long as the discounts exceed the company's cost of working capital, the arrangement usually results in meaningful savings for the customer. Generally, the higher the number of days past discount terms revealed by application of the formula, the more attractive the discount option becomes.

Companies with good payment records also negotiate with select suppliers for more favorable payment terms. For example, a company that is on C.O.D. payment terms may negotiate for account terms, or a company that pays on a net 30 basis may request a prompt-payment discount. The key is to target the right suppliers to leverage the payment arrangements that best support the company's financial objectives.

Leading companies target negotiations by first segmenting the supplier base according to several factors, including dollars spent, transactional volume, and risk of disruption to the supply chain. The segmentation indicates which suppliers might present favorable opportunities to negotiate new terms and which might pose unacceptable risks. Based on those results, finance managers can then work with purchasing or strategic sourcing departments to plan and pitch requests for more favorable payment terms to the appropriate suppliers.

Leading companies also establish invoice payment schedules, based on receipt of goods or receipt of invoice. Establishing invoice payment schedules requires careful consideration and planning. Even when a company and its suppliers agree on 30-day payment terms, there is still the question of when to start counting down those 30 days. Unfortunately, more often than not, companies set up payment based simply on the date printed on the invoice. This means that if the actual invoice takes 15 days to arrive by mail, the company would effectively have only 15 days left to pay. Worse yet, there is no guarantee that the company would have actually received the product within those 30 days. Therefore, unless the vendor contracts specify otherwise, experts suggest that companies set invoice payment schedules based on either receipt of goods or receipt of invoice, whichever comes later. This enables companies to extend the payment cycle as far as possible.

This table illustrates how companies calculate and compare the relative benefits of paying promptly versus playing the float (delaying payment as long as possible):

Sample calculations for changing float for discounts					
Formula	$\frac{\text{Discount rate}}{\text{Cost of capital}}$	x	365 days	=	Days of float needed past discount date to break even from investment in alternative vehicle.
Example 1	$\frac{0.5 \text{ percent}}{20 \text{ percent}}$	x	365 days	=	26 days past discount date to break even
Example 2	$\frac{1 \text{ percent}}{7 \text{ percent}}$	x	365 days	=	52 days past discount date to break even
Example 3	$\frac{2 \text{ percent}}{10 \text{ percent}}$	x	365 days	=	73 days past discount date to break even

B. Automate or eliminate steps in invoice processing.

Many A/P professionals struggle to process an increasing number of invoices with constantly reduced resources. Leading companies leverage current technologies, such as optical character recognition (OCR) and work-flow systems, to digitize invoice documents. These technologies help to reduce errors associated with manual invoice processing and increase processing efficiency.

OCR is a good example of a digital technology that is increasingly used to streamline invoice processing. OCR works by “reading” paper invoices and capturing the necessary invoice-processing information electronically. It eliminates the need for manual input of invoice data and reduces associated input errors. The Australian Department of Defense, for example, is planning to transfer manual processing of 600,000 paper invoices a year to a \$2.6 million state-of-the-art OCR system, as part of an ongoing effort to automate its A/P system.

Companies are also turning to imaging and work-flow systems to automate invoice processing. The imaging process saves time and space by allowing staff to scan paper invoices into digital format. These digital images are then stored as electronic files that can be read by computer applications via disk, tape, CD-ROM, or optical platter. The system also includes an index that allows easy location and retrieval of specific image files.

To better manage the invoices for office supplies, low-dollar inventory, and maintenance, repair, and operations (MRO) purchases, leading companies prefer to make these purchases with purchasing cards, a practice that can reduce A/P transactions by more than 50 percent. Many companies also see cash-flow improvements as a result of using purchasing cards (p-cards). Some of these benefits come from special terms negotiated with the card-issuing bank. Others come in the form of rebates given by the bank, based on the total value of card purchases. The rebates usually range from 0.5 to 2 percent of purchase, and in certain instances, can translate into millions of dollars of savings.

In an approach similar to purchasing card programs, progressive companies are also using web-based catalogs to control employee purchases and streamline the payment process. Employees purchase office supplies and MRO items online through suppliers' web-based catalogs. In turn, suppliers send a consolidated invoice monthly, often using electronic data interchange (EDI) or the Internet, directly to a company's A/P function. Web catalogs often help reduce the number of invoices to be processed and build an audit trail for all purchases. This allows finance staff to identify buyers and confirm that they are authorized to make the purchases shown.

In addition, more companies now eliminate invoicing with evaluated receipts settlement (ERS). Also known as payment on receipt or invoiceless processing, ERS allows companies to settle goods receipts automatically without an invoice. In an ERS arrangement, the company does not require suppliers to provide invoices for order transactions. Instead, the two parties agree in advance on a price by a blanket order or some other type of purchase order. When the company needs supplies, it issues a material release that specifies delivery quantity. The supplier issues an advance shipping notice to confirm the actual quantity delivered so that when the shipment arrives, it triggers payment automatically. The success of ERS depends on a strong partnership with the supplier, mutual agreement on pricing, and joint efforts to keep prices up-to-date. ERS generally works best in a manufacturing environment.

C. Maintain an open line of communication with suppliers.

Despite the vast benefits of automation, the A/P process remains ultimately a relationship-based business. Leading companies analyze their supplier base continually, focusing on the strategic importance of the purchase and the supply risk. Based on risk and value criteria, companies typically divide suppliers into different commodity categories to guide strategic discussions about improving relationships. These categories are noncritical, leverage, bottleneck, and strategic commodities.

In general, each commodity category has its own characteristics and requires an appropriate strategy to maximize sourcing efficiency. For example, noncritical commodities usually comprise relatively low-value and low-risk items, such as office supplies. The objective is to streamline the sourcing process and reduce costs using approaches such as consortium procurement, electronic catalog ordering, or use of purchasing cards.

In contrast, leverage commodities have a relatively high value because of high volume and expenditure levels, but they still remain a low supply risk because numerous suppliers are readily available. Bottleneck commodities are usually specialized products from unique suppliers, such as original equipment manufacturers. These items are not particularly expensive, but they often present a high risk because of limited supply. To minimize risk, leading companies search for substitutes that are standard and widely available or ask one of the suppliers in the leverage quadrant to secure supply as an additional service.

Finally, strategic commodities represent high-cost items obtained from unique suppliers. Because of the high value and high supply risk, relationships are key to success in this category. Finance managers focus on building long-term relationships with strategic suppliers, as well as developing integrated processes and interactive design collaboration solutions whenever appropriate.

Companies are also striving to establish realistic payment schedules with suppliers. Different cash-flow circumstances affect the payment cycle in different industries. For example, the computer hardware industry, which thrives on the rapid release of new products, also generates rapid rates of inventory turnover, collections, and payables. In contrast, the toy industry, which experiences the highest sales during the holiday season, follows slower cash-flow and payment cycles. With this in mind, finance managers consider their particular industry's cash-flow cycle as they arrange payment schedules with suppliers. Companies that set realistic payment schedules—and that abide by those schedules—build trust and credibility with their suppliers.

By reducing the number of suppliers to only key strategic sourcing partnerships, companies usually can negotiate better payment terms, while decreasing the A/P workload and the risk of payment errors.

D.

Boost fraud prevention and detection measures.

A/P fraud has increased in recent years, as more criminals learn to penetrate A/P systems and make illegal transactions. Companies now must protect themselves against a variety of A/P fraud techniques—from unauthorized use of p-cards to illegal electronic fund transfers. Furthermore, fraudulent payments cause companies to misstate liabilities in their financial reports. In response to these security issues, leading companies establish systematic antifraud controls that focus simultaneously on fraud prevention and detection.

Key fraud prevention and detection measures include the following:

- **Publishing a clear code of ethics regarding financial fraud.**

Effective fraud prevention begins with clear communication to employees about the company's ethical standards. Leading companies publish their ethical policies in brochures, handbooks, and intranet documents, so that employees have ongoing access to clear guidelines. To encourage staff to report fraud, leading companies also publish relevant reporting information, such as names and telephone numbers of internal authorities.

- **Segregating the A/P job functions so that no individual employees can single-handedly authorize and access payments.**

By dividing the related tasks among many, companies create an internal check-and-balance system that discourages fraud and enables quick discovery of attempted fraud. For example, a company might assign one A/P team to prepare payment documentation, while another team signs checks and issues electronic payments. Or one team could focus on disbursing funds, while another works on reconciling bank accounts.

- **Employing stringent controls to monitor A/P applications.**

To avoid risk and prevent questionable activity, such as duplicate invoices or unauthorized system access, A/P departments may employ authority delegation tables allowing confirmation that an individual has sufficient authority to approve payment of the invoice. They also establish criteria for flagging invoices as potential duplicates. These criteria might include vendor name and amount and date and number of the invoice. Another policy providing protection is segregation of duties, prohibiting, for example, the same person from updating the vendor master file and entering an invoice.

- **Managing vendor master files closely to reduce potential for payment error and fraud.**

The more vendors a company works with, the more difficult it is to keep vendor information current and accurate. Companies must track this information in order to avoid making wrong or duplicate payments—or worse yet, becoming victims of vendor fraud. Vendor verification is the critical first step to maintaining a clean vendor master file. The capabilities and financial stability of a vendor directly affects its ability to deliver goods or services of appropriate quality within the specified time frame. Before adding a new vendor to the master file, leading companies check the vendor’s business history and credit rating. They also compare the vendor’s phone number, address, and taxpayer identification number against their employee information; any duplication between the two lists likely means that an untrustworthy employee has set up a dummy vendor to extract payment fraudulently. Once a vendor has been verified and approved, leading companies follow rigorous protocols to add the vendor’s information to the master file, and schedule regular reviews to delete or archive old vendor records.

- **Performing random p-card audits.**

Perpetrators have been known to purchase items not related to the company on company p-cards, usurp legitimate company purchases for personal use, and even “pyramid” high-dollar transactions (that is, using multiple card swipes to break transactions into smaller pieces that circumvent card limits). To deter such fraudulent activities, random p-card audits are performed.

Using automated financial system query capabilities, leading companies download p-card transactions made during a specified period and sort them by vendor, date, and accounting transaction number. They analyze the data for unusual buying trends and usage patterns. Suspicious transactions are flagged, followed by requests to the purchaser to provide documentation verifying authorization. If there is enough evidence of fraud, companies also will work with law enforcement and obtain warrants to search the suspect’s property.

Benford's Law, developed in the 1920s by physicist Frank Benford, is the most common form of digital analysis used by auditors. According to the law, the predicted frequency of the first digit in a number decreases as the value of the digit increases. Thus, for example, the law states that numbers beginning with one appear approximately 30 percent of the time in random drawings, while numbers beginning with two appear only 18 percent of the time, and so on. The following table illustrates Benford's predictions of the expected frequencies—rounded to three decimal places—for first and second digits:

Benford's Law		
Frequency		
Digit	First Digit	Second Digit
0	---	0.120
1	0.301	0.114
2	0.176	0.109
3	0.125	0.104
4	0.097	0.100
5	0.079	0.097
6	0.067	0.093
7	0.058	0.090
8	0.051	0.088
9	0.046	0.085

Applying Benford's Law to A/P fraud investigation, auditors expect legitimate A/P transaction data to correspond to the predicted frequencies mentioned above. Data that fails to correspond with these frequencies may signal fraudulent transactions. (Note, however, that Benford's Law applies only to random number sets, not to assigned, nonrandom data. Examples of nonrandom data include numbers indicating preset minimums or maximums, breakpoints, or selected values, such as policy numbers or Social Security numbers. Consequently, nonrandom numbers may not be included in data subjected to Benford's Law analysis.)

E.

Leverage compliance efforts into process improvement opportunities.

The A/P department of Verizon Communications Inc. recently partnered with the Verizon Quality Integration team to find ways to reduce cost and increase efficiencies. The Verizon Quality Integration team strongly recommended a Six Sigma approach for improving A/P efficiency. For its first project, the New York-based telecom services provider reviewed the cost of various payment methods including check, wire, and electronic funds transfer (EFT). While EFT emerged as the least costly payment method, it represented only 1 percent of Verizon's actual payments to vendors. Using the Six Sigma method, Verizon's A/P department identified a potential cost savings of \$1 million to be gained by increasing its use of EFT.

Source: International Quality and Productivity Center's "Accounts Payable/Accounts Receivable Benchmarking Best Practices Forum" 2005 conference program.

As an integral part of corporate finance operations, A/P departments are likewise heavily engaged in compliance efforts. Rather than viewing this as a burden, however, forward-looking A/P departments use compliance efforts to build world-class performance. To ensure that A/P is operating at maximum efficiency and lowest cost, leading companies periodically map work flow with a formal blueprint that charts standard activities, inputs and outputs of each activity, relationships with other functions, and critical decision points. An effective process map uses both words and diagrams to document work flow. By creating a process map for A/P, finance staff may uncover opportunities for eliminating unnecessary and redundant steps, and set priorities for making improvements.

Despite the different concerns of the various international regulatory agencies, they all emphasize the need to tighten internal controls. For example, the Basel II Accord on international banking recommends internal controls as an important part of operational risk management, and the U.S. Sarbanes-Oxley Act states clearly in Section 404 the relationship between strong internal controls and accurate financial reporting. As a result of these recommendations, many companies are now adopting formal internal control frameworks, or adapting existing ones, to strengthen their program.

A majority of U.S. public companies, for example, have adopted the framework authored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission to boost internal controls for financial processes, including A/P. According to COSO's Internal Control-Integrated Framework report, A/P internal controls have five objectives:

- Identify available discounts
- Record invoices accurately on a timely basis for all authorized purchases
- Record returns and allowances accurately for all authorized credits
- Ensure completeness and accuracy of A/P transactions
- Safeguard A/P records

Progressive A/P departments also maintain extremely high standards with little tolerance for deviation. Six Sigma, the process improvement framework pioneered by Schaumburg, Illinois-based Motorola, Inc., is particularly effective when used on highly structured operations such as A/P. Depending on the scale of improvements sought, the scope of Six Sigma projects may vary. Some companies start by focusing on just one aspect of A/P, while others choose to review the entire procurement-to-payment process.

Potential Six Sigma projects include benchmarking the actual A/P process performance with the performance of selected business process outsourcing providers and examining the entire process flow from purchase order receipt to payment receipt. Other possibilities include investigating missed special payment terms and the invoicing process. Also, examining the productivity of A/P processors based on volume of invoices processed per hour and accuracy rate is useful, as is investigating the number of A/P errors the accounting staff finds at the end of the month when preparing the company's financial statements.

According to the Six Sigma doctrine, the key to increasing productivity and quality is keeping as many parts of a process as close as possible to the Six-Sigma level. It is relatively easy for automated processes to reach the near-perfection level of Six Sigmas, or six standard statistical deviations from the mean. But manual processes, such as manual invoicing, rarely rise above Four Sigmas, producing mistakes about six times in every 1,000 opportunities or six incorrect invoices out of every 1,000 transactions. In terms of the A/P process, this means that automation is key to world-class performance. Companies looking to improve A/P must automate as many manual processes as possible, including data entry and invoice processing.

What companies gain

Too often, the A/P process breaks down precisely where invoice processing begins. Companies commonly find themselves spending excessive time tracking delinquent invoices or rekeying invoice information—frequently erroneously—into the A/P database. Worse yet, suppliers sometimes add to the confusion by issuing a single invoice for multiple shipments, thus making the task of matching invoices to receipts even more difficult. As a result, companies waste precious time correcting invoice errors and end up delaying the entire payment process.

Fortunately, companies that apply best practices have found a way to circumvent the problem by leveraging information systems and redesigning the A/P process to automate or eliminate steps in invoice processing. Today, many electronic applications are available to alleviate the need to rekey invoice information or to match invoices with receipts manually. And as much of the routine transaction-processing tasks in A/P become automated, A/P managers and staff can partake in more value-added activities—including a growing focus on nonfinancial performance management, strategic planning, and strict compliance.

For further information on these and
other best practices, visit:
www.globalbestpractices.com

e-mail:
help@globalbestpractices.com

call:
Toll free: 1.800.223.0535
International: 1.813.351.6469