ESSENTIALS
of Accounts Payable

Mary S. Schaeffer

Editor of
IOMA's *Report on Managing Accounts Payable*

WILEY

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for my wonderful, talented son

Benedict Ronald Ludwig

Preface

A common misconception about accounts payable is that it is not very complicated or sophisticated. "What's the big deal?" the skeptics ask. "The accounts payable department just pays bills." Anyone who knows anything at all about accounts payable knows that it *is* a big deal. When the accounts payable function is not handled correctly, duplicate payments abound, check fraud thrives, costs skyrocket, discounts are lost, vendor relations falter, and certain state regulatory agencies may arrive more frequently to perform an audit (unclaimed property and/or sales and use tax). And that is just the tip of the iceberg.

Unfortunately, some accounts payable associates have done a poor job in educating their bosses about the complexities of the accounts payable functions and responsibilities, and the business and financial press has virtually ignored their contributions, as well. The purpose of this book is not only to change those perceptions, but also to provide a solid foundation for those just starting out in accounts payable. Because we've included some brand new areas, including Extensible Markup Language (XML), the Internet, imaging, and more, more seasoned accounts payable professionals will benefit from the book as well.

The book begins with a quick review of the accounting and bookkeeping functions as they relate to accounts payable. It also shows how accounts payable information fits into the big picture and provides some of the foundation information for the company's financial reports.

Because virtually all accounts payable departments pay bills, the chapter on invoice handling is quite thorough in explaining how corporate America handles its invoices and writes its checks. These once-routine chores have now become quite complicated, and if they are not handled correctly, problems will abound. Best practices in both areas are discussed.

Despite accounts payable associates' best efforts, inevitably some invoices need to be processed outside the normal time frame. Exception handling and the Rush check issues are examined in detail. Although it is not possible to completely eliminate Rush checks (Wouldn't that be wonderful!) there are ways to limit the numbers of these annoying items and also limit the problems they create.

Third-party audit firms continue to thrive, collecting duplicate and other types of erroneous payments made by companies everywhere. If duplicate payments were prevented before they occurred, companies would not support this thriving business. The chapter on preventing duplicate payments recommends the best ways to do this. In fact, it contains tips from several well-regarded professionals who make a rather attractive living chasing the duplicate payments made by companies of all sizes.

One of the biggest causes of duplicate payments are payments made when the original invoice cannot be found. Although refusing to pay is not a reasonable approach—after all, mail does get lost—there are ways to pay from a copy without greatly increasing the odds of making a duplicate payment. Chapter 6 looks at the best ways to pay a lost or missing invoice without creating additional problems, that is, making a duplicate payment.

The purchasing–accounts payable relationships in many companies leaves much to be desired. These two departments often do not get along. This is unfortunate because they both benefit from smoother relations. Chapter 7 suggests ways that the accounts payable associate can make this tenuous relationship work even under the most trying of circumstances.

Few companies give their master vendor file the attention or care it deserves. We take a look at the statistics regarding how corporate America treats its master vendor files, the problems that can arise from inadequate care and controls, and ways that companies can best maintain their master vendor file.

Early-payment discounts are near and dear to the hearts of many corporate controllers. It falls on the accounts payable department to ensure that all the discounts are taken. In fact, one accounts payable professional says the only way to get the controller at his company angry is to lose one of these discounts. Chapter 9 explains how these discounts work, why they are so important, and who takes them and under what circumstances. It also examines the deduction issue and the effects of taking unauthorized discounts. This chapter suggests how to work best with suppliers when taking discounts and lists deductions that might be unfamiliar.

Handling travel and entertainment (T & E) expense reports typically falls under the accounts payable umbrella. For many, it is a thankless function that is time consuming and adds little value. Chapter 10 evaluates current processes and recommends ways to make the traditional function operate just a little smoother.

T & E is one of the areas in accounts payable that is experiencing much change. As hotels look for ways to increase income, they have developed some unique ways to increase revenue without appearing to be raising their prices. They are identified so accounts payable associates will be aware of them when they encounter them. Similarly, phone charges have gotten out of hand, and there are ways to fight these excess fees.

Finally, the chapter on T & E in the twenty-first century takes a look at the phenomenon of cell phones and how these instruments are changing the corporate landscape. It also reviews current cell-phone policies and discusses how companies are paying for this new device.

Electronic Data Interchange (EDI) had been around since the late 1970s. Although current projections for future growth are no longer off the charts (thanks to the Internet and XML), most experts believe that this stodgy electronic methodology will be with us for years to come. Thus, most accounts payable associates will need to have some basic understanding of EDI and its impact and use in accounts payable. Chapter 12 addresses these and other related EDI topics.

The Internet has invaded accounts payable departments everywhere, radically changing the way many perform their day-to-day functions. Chapter 13 takes a look at how companies are using the Internet in accounts payable. It also contains many Web site addresses that illustrate many of the points.

XML is revolutionizing the way companies report and share data. Chapter 14 provides accounts payable associates with the basic XML information they need to understand the process and its impact on accounts payable. This is an area that will grow rapidly in the next few years, and it is important that accounts payable associates get in on the ground floor.

P-cards, also referred to as corporate procurement cards, have made a major impact on accounts payable, drastically reducing the number of invoices for companies that make effective use of these cards. Chapter 15 reviews some of the basic data related to p-cards and shares some advice for getting the most out of them. It also evaluates the types of data currently available for general ledger updates.

Fraud, especially check fraud, is a growing problem in corporate America. Companies that do not understand the dynamics and learn how to protect themselves will find themselves victims of the unscrupulous. Chapter 16 reviews some of the more common types of accounts payable fraud and offers suggestions for companies that wish to protect themselves against hucksters looking to take their money.

A number of new technologies, including imaging, interactive voice response units, encryption, and digital signatures are being used very effectively in accounts payable departments. Chapter 17 discusses these technologies and presents a number of case studies that demonstrate how real-life companies have integrated these approaches into their accounts payable departments.

Sales and use tax, escheat, evaluated receipt settlement, benchmarking, audit firms, value-added tax (VAT) recapture, and 1099s are just a few of the other issues handled in a growing number of accounts payable departments across the country. These and other high-level accounts payable concepts are explained in Chapter 18.

Eventually, after working in accounts payable for a number of years, most accounts payable professionals will be given the opportunity to manage a group, first perhaps as a supervisor and then eventually as the manager of the department. Chapter 19 provides an overview of the skills and requirements for that challenging position.

Accounts payable is changing rapidly. The skills and education needed to survive in the past simply won't cut the mustard. Chapter 20 takes a look at the brave new accounts payable world in the twenty-first century and tells our readers what to expect and what they need to do to prepare to be an accounts payable survivor in the next decade.

Good luck—it will be a challenging, yet exciting time.

Acknowledgments

Throughout this book you will see mention of a company called IOMA (Institute of Management and Administration), a New York City–based newsletter publisher. It is the company I work for and is the publisher of, among many others, a monthly newsletter called *IOMA's Report on Managing Accounts Payable.* In my position as editor of this publication since 1995, I have had the opportunity to interact with hundreds of accounts payable professionals and the vendors who provide accounts payable services. It is from these interactions that I am able to develop new material—not only for the newsletter each month, but also for this book.

When we started the newsletter, there was very little published on the topic. IOMA stepped in to fill this void and today those who want information can find it, not only in the newsletter but also in our books, on the Internet, and at conferences. IOMA also produces valuable research for the accounts payable profession. Throughout this book, you will find a smattering of benchmarking statistics. These come from a biannual survey of more than 900 responses from the accounts payable community. They provide a snapshot view of what is being done in today's accounts payable departments in companies of all sizes and in all industries. They are presented to guide the reader toward current best practices.

Without the backing from IOMA in the accounts payable research, neither the newsletter nor the books nor the valuable benchmarking information would be possible.

Contents

CHAPTER 1

Some Accounting and Bookkeeping Basics

After reading this chapter you will be able to

- Understand accounting and bookkeeping as they affect accounts payable and where accounts payable fits into the big financial picture
- Recommend good internal controls for accounts payable policies and procedures
- Avoid common accounting mistakes
- Use common accounting and bookkeeping terminology when discussing accounts payable related issues

In order to fully understand why matters are handled the way they are in accounts payable, it is a good idea to know a little about accounting and bookkeeping. Much of what is done in the department has strong accounting implications. By understanding basic accounting and bookkeeping as they relate to accounts payable, associates will instinctively understand the reasoning behind certain actions. They will also be able to avoid common mistakes that arise from a lack of understanding of the difference between debits and credits. Remember, accounts payable is a lot more than just paying bills.

What Is Bookkeeping?

Bookkeeping is the first step—the recording of all activities and transactions. It is the first step in the accounting cycle. In fact, some of the processes that are commonly referred to as accounting are actually bookkeeping. For example, balancing a checking account statement is actually a bookkeeping function, although it usually falls under the accounting umbrella. Many consider gathering backup information, such as is done in the three-way match, a bookkeeping function rather than an accounting function.

What Is Accounts Payable?

The *accounts payable* figure on the financial statements of any company represents the company's unpaid bills. It is the money owed by the company to its suppliers and other creditors. Accountants break the money owed by the company into two groups: *current liabilities* and *long-term liabilities.* They consider accounts payable a current liability. Current liabilities are those obligations that must be paid in less than one year. Other current liabilities might include taxes and salaries. These are separated from items such as long-term debt repayments that have longer due dates.

Is It Bookkeeping or Is It Accounting?

Don't waste a lot of time trying to determine whether something is an accounting function or a bookkeeping function—it doesn't really matter what you call it. To use an old Shakespearean quote, "A rose by any other name smells just as sweet. . . ." As long as the function is performed correctly, its classification really doesn't matter.

Liabilities

A company's *liabilities* are its obligations. They include items such as bank loans, money owed to vendors (also known as accounts payable), employees' salary, and any other expenses that might arise from the business operations. Typically, liabilities are broken into two categories: short term and long term. Short-term liabilities are typically those that must be paid in the next 12 months while long-term liabilities are those that are due after 12 months.

Thus, accounts payable is almost always a short-term liability. Interest on bank loans is typically considered short term while the principal repayment is classified as long term—until the year they become due.

Assets

The opposite of a company's liabilities are its *assets.* One hopes to work for a company whose assets exceed its liabilities. For accounting purposes, the company's assets are everything it owns. These, too, are broken down into two groups: current and fixed. *Current assets* are items that can be converted to cash rather easily. They include accounts receivable, inventory, and prepaid rent.

Fixed assets are items that are generally not held for resale purposes. This includes items like machinery, real estate, and furniture. Although it is true that most of these items could be turned into cash, this could not be done easily, so they are not considered current or liquid assets.

When analysts look at assets and liabilities, they not only study the relationship between the two, but also look closely at the comparison between current assets and current liabilities. If current liabilities exceed current assets, there can be serious financial consequences.

Expenses

Expenses can be classified several ways:

- *Pre-paid expenses* are monies paid in advance for a product or service. They are actually considered an asset until the expense is incurred. The most common pre-paid expense is insurance, which can sometimes be paid as infrequently as annually.

- *Current expenses* are expenses that have been incurred (and thus are considered a liability) and will be paid within the current period.
- *Accrued expenses* are expenses that a company has incurred but has not been billed for yet. Many companies accrue accounts payable expenses at the end of each month and virtually all accrue them at the end of the fiscal year for financial statement purposes. It is not uncommon to hear accounts payable associates talking about doing accruals at month end.

Using accruals allows the company's executives and bankers and—in the case of public companies, its investors—to have a realistic picture of the company's financial position and obligations. These numbers can be especially meaningful in the case of those companies that employ payment timing or stretching practices.

Accruals

Accounts payable associates will sometimes indicate that they are doing accruals. As just indicated, this is usually done at the end of some sort of a reporting period. Typically, what the associate is doing is calculating the expenses that have been incurred but for which no invoice has been received. This is not done in every accounts payable department but is performed in many.

Chart of Accounts

When accounts payable associates record information, they must have a category with which to associate the information. To do this, most companies assign a reference number or an account number. The list of all these account numbers is called the *chart of accounts.* It is sometimes referred to as the index of the general ledger. Each company develops its own chart of accounts. The number of accounts is limited only by the imagination of the company's accountant and the company's detail requirements. There can be as few as 50 accounts for a small company, or many more. A few nimble accounts payable associates end up knowing the account codes of their most common transactions by heart and rarely refer to the chart of accounts.

General Ledger

The entire chart of accounts for a particular company and all its related information is called the *general ledger.* It is referred to in accounting literature as the GL, sometimes written G/L. It is the information pertaining to the actual accounts, and great care is given to who has access to it and who can update information in it. In fact, there is often great debate about outside information being fed directly into the G/L. Some auditors recommend against this unless strong controls monitor the outside input. Others prefer these updates be done to some sort of a suspense account, with the company doing the update after the outside information has been reviewed.

Debit and Credit Memos

This area sometimes leads to confusion in accounts payable—the results of which can be pretty strange. A *debit memo* is a convenient way of letting a creditor know that the company wants to debit the vendor's accounts payable account for a return, a price reduction, or some other matter. In an ideal situation, the creditor will confirm this reduction by issuing a *credit memo.* As you might have guessed by now, reality is not always so smooth. Sometimes, the supplier will realize it was overpaid and issue a credit memo—which it doesn't give to the customer. The credit balance sits on the account. Eventually, the vendor may simply write off the amount, never giving it to the customer.

IN THE REAL WORLD

How General Ledger Information Is Used

In addition to special company management reports that are produced from the G/L, most companies produce three very important types of reports that are used by lenders, outside investors, and others considering lending money to a corporation.

1. *Balance sheet*—The balance sheet, also referred to as the statement of condition or the statement of financial position, shows the status of the company's assets, liabilities, and owner's equity at a given point in time. Balance sheets are sometimes unofficially called a snapshot view of a company's financial health. Like a snapshot, the view can change seconds after it is taken.
2. *Income statement*—The income statement, also referred to as the profit and loss statement (P & L), summarizes the revenues, costs, and expenses during a given period.
3. *Statement of cash flow*—This report summarizes the organization's cash inflows and outflows for a given period.

Taken together, the balance sheet and income statement make up a company's financial statement. Thus, when a firm is asked to provide its financial statement, it must supply its balance sheet and income statement. Traditionally, the financial statements had been the main tools used to analyze a company's financial performance. However, given some of the gimmicks and one time or extraordinary gains (or losses) that companies sometimes post on financial statements, a number of analysts now also focus on the statement of cash flow.

In the worse-case scenario, the vendor does send the credit memo to the customer and the accounts payable associate, not understanding debit and credit memos, *pays* the credit memo. Now the company has double paid the vendor an amount it never owed in the first place. This, unfortunately, is not an uncommon occurrence, and is one of the reasons accounts payable associates need to understand rudimentary accounting.

Sometimes you will see debits abbreviated as dr. and credits as cr. The abbreviations come from the Latin terms from which the terms are derived, *debere* and *credere.*

Adjusting Entries

When the books are closed, usually at the end of the month, often times adjusting entries will be made. These are generally for items that cannot be recorded in the daily transactions. Many companies close their books several days before the end of an accounting period so they can get all the necessary work completed by the end of the period (usually a month). Additionally, at year-end the books may be kept open to the last possible moment in an attempt to get in every last item.

GAAP

Companies are under great pressure to produce the best possible numbers in their financial statements. If there were no guiding principles, some might be tempted to fudge the numbers. To make sure their statements meet regulators standards, companies must complete their accounting using generally accepted accounting principles (GAAP) standards. This also makes it possible to compare financial reports from one company with those from another. Expect to hear about financial statements prepared using GAAP or according to GAAP guidelines.

The goal of GAAP is to prevent companies from using a variety of creative accounting techniques to make the numbers look better than the company actually does.

Year-End Window Dressing

Companies that rely heavily on their year-end financial statements will sometimes take great pains to make sure the numbers make the company look as good as possible. There is absolutely nothing wrong with this as long as the year-end manipulations are done according to GAAP. For example, a company that normally stretches its payments may decide to pay within terms to avoid showing a large accounts payable balance. Some might view an unusually large accounts payable figure with a skeptical eye, thinking it indicates a problem. Conversely, other companies might decide to stretch payments longer at the end of a fiscal period to show a large cash balance in that period.

Audit Trails

Accountants are famous for talking about audit trails—and with good reason. They make a lot of sense. Whenever possible, make it very clear why and how certain actions were taken. For example, if an invoice is to be short paid, indicate the reason in the file. To make the issue even clearer, some companies pay the entire original invoice and then issue a debit memo to cover the difference. The exact methodology is less important than making the reasoning clear to anyone who comes along. Putting a note in your files might work for the accounts payable department, but if that information is not available to others who might need it, your audit trail might not be very clear.

Suspense Accounts

Sometimes it is not clear to what account an item should be booked. Rather than delay the processing of the item, it is booked to a *suspense* *account* to be researched further at a later date. The theory behind suspense accounts is that they allow the work to proceed and are to be cleaned out shortly when the proper accounting is determined. However, researching items in a suspense account is not at the top of anyone's list, so items often stay in suspense much longer than the company's accountants and controllers would like. Left up to their own devices, many professionals would not use suspense accounts. However, they are a necessary evil if one wants to run an efficient accounts payable department.

Summary

From this very brief review, accounts payable associates can see how very important it is that the company's accounts payable functions are performed and recorded accurately. If not, the company's financial statements will not be accurate and investors and potential lenders could be misled.

CHAPTER 2

Invoice Handling: The Three-Way Match and More

After reading this chapter you will be able to

- Understand all the documents needed to make a payment
- Know the proper procedures for handling invoices
- Identify the problem areas related to invoices
- Handle problem invoices
- Use statements correctly

At the very lowest level, accounts payable's chief responsibility is to pay a company's bills. On the face of it, this might seem simple, but it is not, really. Those who say, "What's the big deal—you get a bill and then you pay it," show no understanding of the corporate accounts payable world. Yes, accounts payable pays the bills—but no, the staff does not just get a bill and pay it. It only does so when proper controls are in place and when the payment is approved.

Payment Process

Three documents normally govern a corporate payment: the invoice, the purchase order, and the receiving documents. We look at each of these in detail in this section.