**MANAGEMENT OBJECTIVE**
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Ensure that the accounts payable process disburses cash effectively and efficiently. The process should maximize profitable cash flow and contain controls that will ensure that transactions are properly recorded and reported.

**BACKGROUND**

**Accounts Payable** is part of the expenditure cycle. The expenditure cycle is a subsystem of the both the cash management system and the accounting system. The other parts of the expenditure cycle are purchasing, receiving, and warehousing. Each of these subsystems should have controls to ensure that its overall objective will be met.

In government, the budgeting process reflects legislated controls over disbursements. The use of the **encumbrance** booking entry reflects these controls.

**DEFINITIONS**

"Accounts Payable" is used in accrual-based accounting to record debts that have been incurred but not yet paid. **Accounts payable** are obligations (debt, liabilities) that will be settled at a future time. They are considered "current liabilities," which means that the debt will be settled with current assets during the current operating cycle.

An **encumbrance system** is a control used in most governmental units to ensure that budgets are not overspent. GASB Cod. sec. 1600.123 defines encumbrances as "commitments related to unperformed (executory) contracts for goods or services." When a purchase order or commitment is placed, the entity reduces the amount of budgetary authority remaining, and records an outstanding encumbrance. When the goods or services have been received, the encumbrance balance is reduced and an expenditure or a liability is recorded.

**Lapse** refers to the termination of certain appropriated funds when budgeted appropriations are not encumbered within the time allotted for use. Unencumbered appropriations appearing at the end of a budget period or at the end of the legislated period for commitment must be lapsed to the State's General Revenue Fund. The time allotted for use varies between agencies but is usually either the fiscal year or the biennium.

A **concentration / zero balance account system** establishes a central concentration account whose deposits are regularly swept for investment. The system feeds numerous zero balance accounts that are funded only for settlement of specific obligations. In practice, it would function as follows: At the end of the business day, funds are converted from short-term investments and electronically transferred through the concentration account to the zero balance accounts. The amounts converted and transferred settle the exact amount of transactions in the demand accounts leaving no balance; hence, the name zero balance (Allan, p.59). (See definitions of "concentration account," "zero balance account," and "sweep account" in the Cash Management section of this manual.)

**Float** is the time between a payment transaction and the actual receipt and/or disbursement of funds at the depository. A cash transaction has zero float because the payment can be immediately used. Other payments usually go through three stages of float -- mailing, processing, and clearance. **Collection float** is the time elapsed between collection and availability of cash to the entity at its depository. **Disbursement float** is the time elapsed between disbursement and actual deduction from the entity's available cash at its depository.

**OVERVIEW OF THE PROCESS**

The basic phases of an accounts payable process are:
- **Ensure that the process provides for an analysis of accounts payable.**
- **Establish policies and procedures for the authority to commit funds and segregate duties while maintaining maximum efficiency.**
- **Optimize the use of cash by coordinating with receivables, investments, purchasing, and other departments to maximize profitable cash flow and disbursement float.**
- **Ensure that the system properly records and reports payables.**
- **Monitor and reevaluate the system.**

**PROCEDURES**

Suggested procedures, organized according to the elements of a finding, are listed below. They should be expanded or tailored to fit the specific entity being reviewed.

Note: The following procedures and the process described above are normative, rather than prescriptive. That is, they represent "average" or baseline thinking since they assemble information which repeatedly appeared in the various resources used to prepare this module. Do not be too hasty or literal in applying a given criterion or procedural step to a specific entity. While omissions or variations may be <u>obvious</u>, judgment must still be used to determine whether such omissions or variations are <u>material</u>.

**Review criteria:**
**General criteria**

General criteria applicable to the accounts payable process are as follows:

Accounts payable has four objectives:
1. provide reliable data to management
2. ensure efficient and effective management of disbursements to maximize disbursement float
3. minimize unnecessary or premature expenditures
4. ensure the accurate recording and reporting of payables

Generally, a good disbursement system will minimize the amount of cash on hand and make sure that all assets are working for the entity.

**Specific criteria**

The criteria related to the basic phases of the performance appraisal process are as follows:

**Ensure the subsystem provides for analysis of accounts payable**.

Key personnel charged with disbursing funds to satisfy entity debt and management responsible for overall cash management must be assured that the data they need is available from the subsystem. A state entity should analyze its payment patterns (including length of time to process payments and the time taken for warrants to be presented) to see if the timing or flow of purchases should be changed. This data and information bearing on the type of payment methods used, along with the location of disbursement facilities (remote location disbursement), should be easily retrievable from the accounting system.

**Establish policies and procedures for the authority to commit funds and segregate duties while facilitating maximum efficiency**.

The process should clearly document the authority and procedures to commit funds. All statutory and regulatory limits must be acknowledged and the process designed for compliance. In governmental accounting, the *encumbrance* is used to track funds committed so that appropriations budgeted to the entity will not be over-committed. When purchased items or services are delivered, the encumbrance entry is credited with a debit to the appropriate expenditure.

Because the account payable is a liability that will be satisfied in the current operating cycle (calendar or fiscal year), it is settled with current assets. This distinction between the account payable and the encumbrance must be clearly delineated. Under Texas law and regulatory procedures, the encumbrance can be carried beyond the end of the operating cycle. This occurs frequently due to the biennial nature of Texas' budgeting system. Unencumbered appropriations appearing at the end of a budget period or at the end of the legislated period for commitment must be lapsed to the State's General Revenue Fund.

**Optimize the use of cash by coordinating Accounts Payable with investments, purchasing, and receivables to maximize profitable cash flow and disbursement float.**

Cash management policy seeks to minimize collection float and maximize disbursement float. Profitable cash flow will be maximized if the entity:

- prevents unnecessary prepayments
- facilitates prompt payment of debt
- avoids duplicate payment
- maximizes disbursement float through concentration/ zero balance account system and payment through remote locations
- coordinates with purchasing to avoid unwarranted fiscal year-end expenditures and allow for the expenditures to spread evenly throughout the operating cycle to maximize the use of cash for investment

The entity should document procedures that:

- ensure cash discounts are taken whenever they maximize transaction profitability
- ensure all exemptions from sales, federal excise, or other taxes are claimed
- ensure that there are not excessive bank accounts, and that the balances for non-investment accounts are kept reasonably low

**Ensure that the system properly records and reports payables.**

As in other subsystems that comprise the accounting system, the accounts payable process depends on a system of internal controls that guarantees the accuracy of the recording and reporting of expenditures and current liabilities. The adequacy of the internal controls ensures the accuracy of accounted debt and thus the security of the assets and balances as stated. Suggested tests of internal controls for accounts payable will be detailed in the *control discussion* to follow. Certain aspects of the payable accounting system to review and test are:

- Type of system -- hard copy (warrants), electronic transfer, or combination
- Purchasing procedures
- Encumbrance recording and budget monitoring
- Processing payables
- Processing and recording leave accruals
- Internal controls

General criteria applicable to financial reporting on accounts payable balances are as follows:

- Accounts payable reported on the balance sheet actually exist at that date (Existence Assertion).
- Accounts payable that should be included in the financial statements are included and there are no undisclosed liabilities (Completeness Assertion).
- Accounts payable represent liabilities for which the entity has legal obligations or, if in a fiduciary fund type, that the third party for which the fund is established has a legal obligation (Obligations Assertion).
- Accounts payable are included in the financial statements at appropriate amounts; that accounts payable are properly measured (Valuation Assertion).
- Accounts payable obligations are properly classified, described, and disclosed in the financial statements (Presentation and Disclosure Assertion).

**Monitor and reevaluate the system**

The system's operational responsiveness depends on regular monitoring and consistent reevaluation of subsystem policies and procedures. The process planning and goal setting will prove pointless if the system does not guarantee the security of assets and the accuracy of the accounted balances. To be effective, the system must be fully operational. Payable accounts should be regularly monitored and analyzed for:

- balances in disbursement accounts
- purchasing patterns (fiscal year-end surges should be avoided)
- lease versus purchase analysis
- appropriate use of electronic fund transfer
- processing procedures — time (disbursement float)

These analyses will allow management to assess adjust performance.

Input from all employees working with the system or dependent on its data should be solicited. This information should be used in a process of upgrading and improving the subsystem.

**Assess Condition:**
**Determine the actual processes used**

Conduct interviews, observe operations, and identify and collect available documentation in order to gain an understanding of the entity's actual accounts payable process and controls. Included in the actual process are both official/formal and unofficial/informal processes and controls. A process may exist even if it is not documented. Possible procedures include, but are not limited to:

- Determine how the entity plans for accounts payable system and the relationship of its procedures and policies to other parts of the accounting and cash management system.
- Determine that accounts payable gathers data for regular analysis of disbursement float, disbursement account balances, discounts on invoice payments, etc.
- Determine if the process used by the entity to analyze purchase needs is adequate and maximizes cash flow.
- Obtain information that demonstrates reports that analyze the performance of the accounts payable process, if available.
- Interview employees and management to determine how these reports are used.
- Obtain subsystem information that indicates that the controls and procedures over accounts payable are reasonable and are reviewed for cost/benefit.
- Determine where the accounts payable process resides in the entity, who participates in the process, and how the participants are selected.
- Obtain and review any manuals, policies, and forms that could document any phase of the accounts payable process, including its relationship to entity goals, objectives, strategies, and plans.
- Determine if and how management consciously selects and employs the assumptions, criteria, methods, processes, and techniques used in the accounts payable process. Obtain and review available documentation on the assessment of risks, costs, and benefits.

In addition to gaining an understanding of the actual process, also try to find out:

- how the participants view the actual process
- what parts of the process they see as successful or unsuccessful, and why
- what they think is important about the process, and why

This information may help identify causes and barriers.

Analytic procedures are "evaluations of financial information made by a study of plausible relationships from among both financial and nonfinancial data." (SAS 56). Relationships that may be significant with respect to payables include:

- Compute ratios such as accounts payable divided by purchases, or accounts payable divided by total liabilities. Compare with ratios from prior years and investigate significant changes.
- Compare over time how long it takes between receiving an invoice and making a payment. A significant change should be explained.
- Consider payables in relation to purchasing volume -- there should be a direct relationship.

**Determine the strengths and weaknesses of the actual process**

Using the tailored criteria, the understanding of the entity's process gained above, and the procedures in this section, analyze the actual process to determine if it:

- is designed to accomplish the management objective (this module, page 1);
- has controls that provide reasonable assurance that the process will work as intended
- is implemented and functioning as designed
- is actually achieving the desired management objective(s)

Suggested procedures for each of these four analysis steps are detailed below. In executing these procedures, remember to identify and analyze strengths and weaknesses.

Identify and review the steps in the actual process to determine if the process is designed to accomplish the management objective(s). Possible procedures include, but are not limited to:

- Determine if all major steps in the criteria are included in the actual process. If steps are missing, determine if their absence is likely to have a materially negative effect on the accounts payable process at the entity you are reviewing.
- Determine if all the steps in the process appear to add value. If there are steps that do not appear to add value, try to get additional information on why they are included in the process.
- Review the order of the steps in the process to determine if it promotes productivity.
- Review the level of technology used in the process to determine if it is up-to-date and appropriate to the task. Besides computer, electronic, communications, and other mechanical technology, you should also consider what kinds of management technology are used (Gant charts, process maps, decision matrices, etc.). See the appendix to the module on problem-solving and decision-making for more information.

Identify the controls over the process and determine if they provide reasonable assurance that the process will work as intended. These controls should be appropriate, placed at the right point(s) in the process, timely, and cost effective. Possible procedures include, but are not limited to:

- Draw a picture of the process, the controls, and the control objectives (see the graphic of the procurement process in the Introduction for an example). Flowcharts of the accounts payable process can help identify inputs, processes, and outputs.

- Determine if the control objectives are in alignment with the overall management objective(s) (this module, page 1).
- Identify the critical points of the process (i.e., those parts of the process most likely to determine its success or failure or expose the entity to high levels of risk) and the controls related to them. Consider whether the controls are:
  - in the right location within the process (input, operations, output)
  - timely (real time, same day, weekly, etc.)
- Compare the cost of the control(s) to the risk being controlled to determine if the cost is worth the benefit.
- Determine how the overall effectiveness of the accounts payable process is monitored and evaluated, and how the entity makes sure that the process is adjusted as necessary.
- Identify, describe, and assess the process used to gather input from employees who might reasonably discover flaws in the process.
- Review the control environment. Assess the impact of factors such as:
  - management's philosophy and operating style
  - organizational structure
  - policies and practices
  - methods for assigning authority and responsibility
  - methods for monitoring and assuring performance
  - impact of external factors
- Determine if management has appropriate control procedures in place to ensure the attainment of the objectives of the accounts payable subsystem. These procedures should address:
  - Quality of personnel
  - Segregation of duties
  - Supervision and Authorization procedures and policies
  - Design and use of adequate documents and records
  - Controlled access to assets and records
  - Independent checks of performance and accuracy (external audit) (AICPA, p.75)
- Review controls established to ensure that the subsystem is regularly monitored and reevaluated. Determine that these controls effectuate management control and the efficiency of the process. (If the control is an end in itself, the process won't be effective.) Determine that the controls ensure evaluation information is used to attain the objectives of the entity.

Review observations, interviews, documentation, and other evidence and design specific audit procedures as needed to determine if the process and/or the controls have been implemented and are functioning as designed. Depending upon the objectives of the project, these procedures may include both tests of controls and substantive tests, more information on which is found in *The Hub*, p. 2-B-8, et seq.. Possible procedures include, but are not limited to:

**Tests of Controls**

- Observe the compilation of an accounts payable analytical report and verify the procedures used to compile the data.
- Evaluate the effectiveness of the entity's use of analysis tools.
- Walk through the actual process, i.e., follow a transaction through the people and documents involved, and compare to the official process.
- Observe the following functions to determine that segregation of duties exist as prescribed. (Note: Some of these functions may be observed when gaining an understanding of the control structure.)
  - Purchasing/procurement
  - Receiving
  - Accounts payable/encumbrance record-keeping
  - General ledger record-keeping
  - Disbursing
- Select a sample of reconciliation of vendor statements with recorded amounts payable (for an encumbrance system, reconciliations will consist of outstanding purchase orders and the reserve for encumbrances amount) and verify the following:
  - Reconciliation is performed by an independent employee.
  - Reconciliations are being prepared in a timely manner.
  - There is evidence of supervisory review and approval.
  - Reconciliations are mathematically accurate.
  - Differences are adequately corrected or resolved.
- Determine if any evidence of management override exists.

**Substantive Tests** (tests of management's assertions)

- **Existence:** Can be tested by vouching source documentation underlying the accounts payable entries. This may be done by obtaining reconciliations of vendor statements with recorded amounts payable. Test the reconciliation as follows:
  - Foot and cross-foot.
  - Test the existence of supporting vendor statements.
  - Review reconciling items for reasonableness and correctness.

  Consider reviewing contract terms, determining good or service received but not paid, review subsequent disbursements.

- **Completeness:** Can be tested by reconciling and recalculating the vendor statements with amounts entered in the accounts payable ledger. Verify that the proper fund, object code, account, and fiscal year are used to record the payable or encumbrance. Compare to open purchase orders and unpaid receiving reports. Verify encumbrance entry is properly made at the time the purchase order is executed and recorded. Verify that budget restrictions are met. Review subsequent disbursements.

Search for unrecorded liabilities and obligations. Possible procedures include the following:

- Scan cash disbursements subsequent to the balance sheet.
- Make inquiry of a responsible agency official regarding other sources of contingent or unrecorded liabilities.
- Examine files of unmatched receiving reports and unpaid invoices. Determine if the file contains unrecorded encumbrances or liquidated payables.

• **Obligations:** Can be tested by reviewing documents that create financial responsibilities for the entity. For example, contracts, vendor invoices, actuarial valuations, and loan provisions can be reviewed for significant accounts payable amounts. Consider testing these or other legal documents for compliance.

• **Valuation and Allocation:** Can be tested by assessing reasonableness of accounts payable and encumbrances totals at year-end in relation to expenditure totals. Another analytical procedure is to perform a fluctuation analysis. If reasonableness questions arise as a result of these procedures, obtain explanations and verify the validity of the explanations. If valuation (proper amount) is questionable, test balances to invoices; if allocation (proper period) is questionable, test year end payables to encumbrances and expenditures.

Test accounts payable detail and support for the following:

- goods and services were received prior to year end
- correct amount, including reasonableness of estimates
- charged against the proper fund or account group

• **Presentation and Disclosure:** Will use a system of *inquiry* to ascertain from minutes of the entity's board and a representation from management to discern whether debts have been satisfied, properly stated, or reclassified. Review all significant reclassification and adjustments related to payables. Determine that accounts payables are presented and disclosed in compliance with the State Comptroller's reporting requirements for annual financial reports of state agencies and universities. Ensure proper differentiation among payables, encumbrances, expenditures, and other debt obligations such as long-term debt.

Review and analyze any reports used by the entity to monitor the outcome(s) of the accounts payable process and/or any other information available to determine if the process is actually achieving the desired management objective(s) (this module, page 1). Possible procedures include, but are not limited to:

• Analyze process reports over time for trends.

- Discuss any apparently material negative or positive trends with management.
- Determine if and how management acts upon these trend reports and what changes, if any, were made in the process or controls as a result. Some process refinements, especially those affecting entity mission, goals, and outcome measures, may need to wait until the next appropriation cycle.
- Acquire reports reflecting expenditure/encumbrance activity. Review these reports for fluctuations and obtain explanation for any unusual or concentrated purchasing activity. Determine reasonableness of explanation and investigate impact on cash flow.
- Review reports on banking activities and focus on balances in demand accounts. Determine if a concentration zero/balance account structure is used or has been considered by management as appropriate for the entity.

**Determine causes**

Determine what circumstances, if any, caused the identified weaknesses in the accounts payable process. Consider materiality of the effect, before spending much time determining the causes. Possible procedures include, but are not limited to:

- Determine if the participants understand both the purpose of and their role in the accounts payable process.
- Determine if the relationship between the accounts payable process and other entity processes is clear.
- If the process occurs at multiple locations, determine the nature and scope of the communication and coordination among components.
- Determine if the accounts payable process has adequate human, dollar, time, and asset resources. If they appear inadequate, determine if entity resources have been allocated according to the materiality of the accounts payable process relative to other entity processes.
- If there are negative trends in the reports used to monitor the outcome(s) of the accounts payable process, determine if these reports are communicated to and used by the appropriate parties to modify the process.

Determine what internal or external constraints or barriers, if any, must be removed in order to overcome these identified weaknesses. Possible procedures include, but are not limited to:

- Review the applicable entity, state, or federal laws or regulations to determine if any of them prevent the necessary changes from being made in the accounts payable process.
- Determine if any key employees are unwilling to change the process and why they are unwilling.

**Determine effect**

Compare the actual entity process to a recommended alternative process(es) and determine if each weakness in the entity process is material. Alternatives can be developed by using the criteria contained in this module, applying general management principles to the processes at comparable entities, etc. Materiality can be measured by comparing the dollar cost, impact on the economy, risks, etc., of the actual process to the recommended alternative process(es). Measurements can be quantitative, qualitative, or both. Possible procedures include, but are not limited to:

- Identify benchmarks (industry standards, historical internal data, other comparable entities, etc.) for the process in question and compare to actual performance. Measure the difference, if possible. Include the cost of the additional controls or changes in the process.
- Estimate the cost of the actual process and the alternative process(es) and compare.
- Estimate the quantity and/or quality of services provided by the actual process and by the alternative process(es) and compare.
- Identify the risks associated with the actual process and with the alternative process(es). Measure and compare the risks.

**Develop recommendations**

Develop specific recommendations to correct the weaknesses identified as material in the previous section. In developing these recommendations, consider the tailored criteria, kind of process and control weaknesses identified, causes and barriers, effects, and additional resources listed at the end of this module. Possible procedures include, but are not limited to:

- Solicit solutions and recommendations from client.
- Identify alternative solutions used by other entities.
- Identify solutions for removing barriers.
- Provide general guidelines as to the objectives each solution should meet; then the entity can tailor the solution to its specific situation.
- Provide specific information, if available, on how each recommendation can be implemented.

## RESOURCES

**Books/Documents**

AICPA. *Audit and Accounting Guide for Audits of State and Local Governmental Units*. New York, New York: AICPA, 1986. Location: SAO Library.

AICPA. *Audit and Accounting Manual*. Chicago, Illinois: Commerce Clearing House, Inc., 1992. Location: SAO Library.

AICPA. *Codification of Statements on Auditing Standards*. Chicago, Illinois: Commerce Clearing House, Inc., 1993. Location: SAO Library.

The Council of State Governments. *Preferred Accounting for State Governments*. Lexington, Kentucky: The Council of State Governments, 1983. Location: SAO Library.

Defliese, Philip L. *Montgomery's Auditing*. New York, New York: John Wiley & Sons, 1975. Location: SAO Library.

GAO. *Government Auditing Standards* (Yellow Book). Washington, D.C.: The Comptroller General of the United States, 1994. Location: SAO Library.

GASB. *Codification of Governmental Accounting and Financial Reporting Standards.* USA: GASB, June 30, 1993. Location: SAO Library.
Robertson, Jack C. and G. Frederick Davis. *Auditing*. Plano, Texas: Business Publications, Inc., 1982. Location: SAO Library.

SAO. *Audit Materials Package*. Austin, Texas: SAO, 1993. Location: SAO

Texas Comptroller of Public Accounts. *Annual Financial Reporting Requirements for Colleges and Universities*. Austin, Texas: Texas Comptroller of Public Accounts, 1993. Location: SAO

Texas Comptroller of Public Accounts. *Reporting Requirements for Annual Financial Reports of State Agencies*. Austin, Texas: Texas Comptroller of Public Accounts, 1993. Location: SAO

Tolson, David A. et al. *PPC'S Controllership Guide*. U.S.A.: Practitioners Publishing Company, 1992. Location: SAO Library.

**Data Bases**

Uniform Statewide Accounting System (USAS)
Human Resource Information System (HRIS)
Uniform Statewide Payroll System (USPS)
Higher Education Data Base
Statewide Consolidation (CAFR)

**Human Resources**

The following staff members have specialized training or ongoing interest in accounts payable:

| SAO Employee | Title/Function |
|---|---|
| David Gaines, CPA | Points of Contact |
| Terry Harris, CPA<br>Linda Lansdowne, CPA<br>Rachel Cohen, CPA | Module Writers/Editors |
| Dick Dinan, CPA<br>David Gaines, CPA | Reviewers |
| Barbara Hankins, CPA<br>Charles Hrncir, CPA<br>Catherine Smock, CPA | Upper Reviewers |

**Periodicals**

Note: Indexes and abstracts of periodicals in bold-faced type are available in the SAO Library via ABI/INFORM.

*Accounting Review*
Published monthly by the American Accounting Association
Location: The University of Texas, Perry-Castañeda Library (HF 5601 A6)

*Accounting Today*
Published biweekly by Lebhar Friedman, Incorporated
Location: SAO Library

***CPA Journal***
Published monthly by the New York Society of Certified Public Accountants
Location: The University of Texas, Perry-Castañeda Library (HF 5601 N54)

*Journal of Accountancy*
Published monthly by the American Institute of Certified Public Accountants
Location: SAO Library

**Professional Associations**

American Institute of Certified Public Accountants
New York, New York
(212) 596-6200

Council of State Governments
Lexington, Kentucky
(606) 231-1939

Governmental Accounting Standards Board
Norwalk, Connecticut
(203) 847-0700

Government Finance Officers Association
Chicago, Illinois
(312) 977-9700

**Related Modules and Reports**

Accounts Receivable
Cash Management
Inventory
Investments
Procurement