Internal Controls for Accounts Payable

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How to Implement Internal Controls for Accounts Payable

Opening a business carries just as many risks as it does rewards. One of the best ways to mitigate those risks is by implementing internal controls.

While internal controls are important for all aspects of your business, they're particularly important in your accounts payable department.

What Are Internal Controls?

Internal controls are a set of established policies and procedures designed to minimize risk while helping businesses achieve their goals. Internal controls include everything from determining company values to monitoring set policies for compliance.

The 5 Components of Internal Controls Your Business Needs

Even the smallest business should have internal controls in place. The internal control framework commonly used by businesses includes five components:

1. ## Control Environment

   Set and modeled by organizational leaders, the control environment includes setting company values, developing HR policies and procedures, creating an organizational structure, and dictating management style.

2. ## Risk Assessment

   Risk assessment is used to determine what level of risk a business currently faces, allowing the business to implement policy to mitigate that risk.

3. ## Control Activities

   Control activities are set into place to ensure that policy is being followed throughout the organization. Segregation of duties is an example of a control activity.

4. ## Information and Communication

   This internal control is used to allow management to identify potential issues in a timely fashion. Financial reporting is one example of information and communication.

5. **Monitoring**

Monitoring of any established internal controls is essential. While policies and procedures are necessary for managing a company properly, they must be regularly monitored to ensure complete compliance.

What Are the 3 Categories of Internal Controls for Accounting?

While internal controls are important for your business, responsible business owners will need to take it a step further and create internal controls for the accounting department, and more specifically, for the AP department.

For accounting, there are three main categories of internal controls: detective, preventive, and corrective, with all three required to safeguard your business.

1. **Detective Internal Controls**

Detective internal controls are used to detect issues after they have occurred. Detective internal controls include performing a regular inventory of products, reconciling bank statements, running financial statements regularly, reconciling general ledger accounts, and performing internal audits regularly.

The purpose of using detective internal controls is to spot a minor issue before it becomes a major one.

2. Preventive Internal Controls

Preventive internal controls are used to prevent issues such as fraud or theft from occurring. Preventive controls in AP are particularly important, as the goal of most businesses is to prevent fraudulent or erroneous activity before it starts. Some examples of preventive controls for AP include:

- **Segregation of duties** – Segregation of duties is one of the most important internal controls. Simply put, the segregation of duties means that multiple employees are responsible for common accounts payable tasks such as entering invoices, approving invoices, reconciliations, and processing payments.

  For example, if you have one person approving a new vendor, entering and approving an invoice, and paying that invoice, that's an open invitation to fraud.

- **System access controls** – Accounts payable system access controls are easily managed. Staff members should receive access to the areas that they need to do their job, and nothing more.

3. Corrective Internal Controls

Corrective internal controls are used to make corrections after discrepancies have been discovered. This discovery usually happens after an audit or reconciliation has been completed. Corrective internal controls include updating policies and procedures and instituting ways to ensure that the corrective measures are being followed going forward.

Depending on the problem discovered, corrective internal controls may also include disciplinary action such as a formal warning, or termination, depending on the severity of the issue discovered.

Accounts Payable Internal Controls to Implement

Once your business has established the appropriate internal controls across the accounting department, you need to delve a little further and establish AP internal controls to protect your monetary assets. AP controls include:

Obligation to Pay Controls

Obligation to pay controls cover four areas in the accounts payable process; purchase order approval, invoice approval, three-way matching, and duplicate payments. You'll also need to have a payment approval process in place for invoices that do not require a purchase order.

- ### Purchase Order Processing and Approvals

  The procurement department should issue a purchase order for all approved purchases. This process approves all spending before an order is placed.

  Because of this, the purchasing department should ask for a completed requisition prior to placing an order.

  Since purchase orders require approval prior to an invoice being received, the invoice will not need to be routed to an approver before processing, provided that it matches the purchase order and shipping receipt.

- ### Three-Way Matching

  Even with an approved purchase order in hand, an AP clerk should still use the three-way match, which matches the purchase order, supplier invoice, and receiving documentation.

  If your business is small and your paperwork is in order, this process is fairly straightforward, but larger businesses may find the process time-consuming.

  This can be rectified by using AP automation, which will match all the required documents electronically, flagging you when something doesn't match.

- ### Invoice Approvals

  For orders placed that do not require a purchase order, an invoice received from a vendor or supplier will need to be routed to an approver.

  It may be better to route the invoice to the person who ordered the goods or services and then route it to a secondary approver so that two sets of eyes look at the invoice.

- ### Duplicate Payment Search

  Another reason to consider making the switch to AP automation is that the system will automatically search for duplicate payments.

  Again, very small businesses will be able to complete this task manually, but if you commonly process hundreds of invoices monthly, the task can become overwhelming, particularly for a small AP staff.

Data Entry Controls

Data entry controls ensure data entered in accounts payable has a standard process. This greatly reduces the risk of manual entry errors. Using AP automation software can greatly reduce the need for manual data entry but you should have controls in place as a fallback.

- ## Standardize When Data is Entered

  There are two ways to enter accounts payable invoices; as soon as they are received or after they have been approved.

  If you currently have a purchase order system or a procure-to-pay software like PLANERGY, you can eliminate the need for invoice approval prior to entering the information, as all purchase orders should already be approved before the invoice is received.

  If you don't use a procure-to-pay system or the majority of your invoices are sent without a purchase order already created, it's better to enter the invoice after it's been approved.

  Whatever process works for your business, it's important that it's clearly communicated to all staff members. Let's look at the differences between these two approaches.

  - ### Enter Invoices Prior to Approval

    If you're using a purchase order system, entering vendor invoices prior to approval is fine, as the purchase order has already been approved. Invoices should not be entered before approval if a purchase has not been issued for the purchase.

  - ### Record After Approval

    Any invoice received without a purchase order in place should be approved prior to entering it into your accounting application. In some cases, a vendor file may need to be reviewed prior to approving an invoice.

- ## Establish Invoice Number Guidelines

  One of the biggest causes of duplicate payments is not entering an invoice number as it's shown on the invoice.

  For example, an invoice is received and entered into the system with the number 000123. Three weeks later, a duplicate invoice is received, but this time, the AP clerk enters the invoice number as 123.

If a payment is processed for both invoices, the system will not flag it as a duplicate payment. Establishing guidelines for entering invoice numbers will help.

Payment Controls

Along with the segregation of duties, which is mentioned earlier, there are other payment control measures that need to be properly managed, including the following:

- ### Split Payment Responsibilities

  Once an invoice has been approved for payment, one employee should be responsible for processing payments with a second employee approving the electronic payment, ACH transfer, or signing the check.

- ### Store Company Checks in a Secure Location

  The only people that should have access to company check stock are the employees responsible for processing payments. Check stock should always be stored in a secure location, along with any signature stamps, if they're used.

  Bank account numbers should also be restricted if electronic payments are utilized.

- ### Keep Track of Check Numbers

  Paying attention to check numbers is important, especially for those processing payments manually. It's important that there is no gap in the check number sequence between the last check used for a previous check run and the first check to be used for the current payment cycle.

  If you're using an automated accounting system, it will track check numbers automatically, but be careful if the system allows you to override the check number sequence.

- ### Check Signing Procedures

  While it's recommended that all checks should be signed manually, this may not be practical for very large businesses. If that's the case, making the transition to an automated AP application may be the best solution, which eliminates the need to use checks in most if not all situations.

- ### Create a Two-Signature System

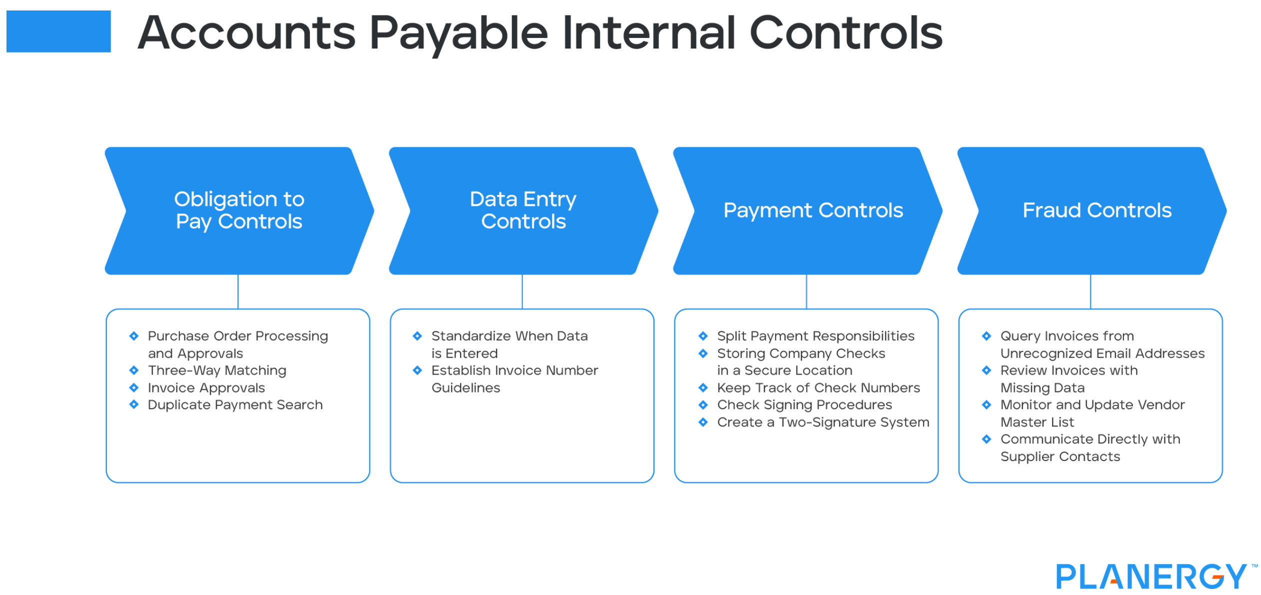
  For checks over a certain amount, consider adding an additional safeguard such as requiring two signatures. Again, having a second set of eyes on a check may discourage theft or fraudulent activities from occurring.

Fraud Controls

Many of the internal controls instituted in AP are designed to reduce payment fraud, but the possibility still remains. Even something as simple as having one employee handle check processing and another handle the bank reconciliation can help stop fraud or identify it if it does occur.

External fraud also needs to be monitored for, here are a few additional checks to help identify supplier procurement fraud:

- Query any invoices coming from unrecognized email addresses
- Review more fully invoices with missing data (like tax ID number or PO number)
- Monitor and update vendor master list regularly
- Communicate directly with trusted supplier contacts if in doubt



What Are the Benefits of Having Internal Controls?

Internal controls provide a necessary level of consistency throughout a business. Establishing and communicating these internal controls to employees helps them understand exactly how a business operates and what is expected of them.

Having internal controls in place also helps a business remain compliant with established rules and regulations while helping to mitigate fraud and human error. Other benefits of internal controls include:

- It improves company performance by identifying areas that need work
- It improves efficiency by removing repetitive steps
- It keeps company information organized, and provides a clear audit trail
- It improves accountability by establishing roles and requirements for those roles
- It keeps the company in compliance with regulations like the Sarbanes-Oxley Act

What Are the Results of Poor Internal

Accounts Payable Controls?

Implementing and following internal controls helps protect businesses from a variety of problems.

So, what happens when a business fails to establish internal controls or fails to oversee that they are being carried out properly?

- ## An Increase in Fraud

  Without internal controls like an established invoice approval process, separation of duties, and three-way matching in place, the likelihood of fraud increases tenfold.

  Implementing and monitoring internal controls keeps your employees honest and your bank account safe.

- ## An Increase in Errors

  Mistakes may not be as costly as fraud, but they can still add up. Duplicate payments, invoices paid for the wrong amount, and invoices not paid at all can prove to be costly to your business, both monetarily, and by impacting business relationships with your vendors.

- ## Inaccurate Reporting

  Business owners, accountants, CPAs, and investors rely on financial reports to be accurate. Managers and owners often make important decisions based on financial reports alone, and banks and other lenders can approve or deny a loan based on financial statements. It’s important that they are accurate.

- ## Compliance Penalties

  Any publicly traded company is required to comply with laws and regulations set in place by various agencies.

Whether it's ensuring that your taxes are paid properly, or that you're complying with other regulatory requirements, implementing and enforcing the proper internal controls is essential. When a company is out of compliance, it often results in hefty penalties.

How Do You Control Accounts Payable Effectively?

The best way to adequately control the accounts payable process is for the CFO, controller, or finance manager to implement and enforce strong internal controls for the department.

Doing so can reduce costly fraud and duplicate payments while ensuring that employees are following policies and procedures properly.

While implementation is the first step towards controlling payable data properly, controls do no good if they're not properly enforced.

Enforcement can take many forms, with the most effective enforcement being regular audits performed.

Whatever method you use to enforce your accounts payable internal controls, remember that creating an effective AP process using accounts payable automation can help reduce fraud, eliminate erroneous and duplicate payments, and help keep financial assets secure.

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