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TAPN Poll

Do you test your department's internal controls?

Yes, we test most of our controls 65%

Yes, but we tend to focus only on problem areas .15%

No, we almost never test our controls16%

Test them? We don't even have them in place!.....4%

"A door is what a dog is perpetually on the wrong side of."

— **Ogden Nash**

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Put Your Controls to the Test

An accounts payable department is only as strong as its internal controls. A weak segregation of duties or a lax invoice approval policy can leave your organization vulnerable to fraud. Establishing strict internal controls around transaction processing will eliminate the gaps that fraudsters love to exploit.

Organizations spend considerable effort drafting their internal controls manuals, making sure that processes are efficient, cost-effective, and safe from fraud. However, accounts payable departments can change over time. Maybe someone left your department, or you hired a new employee or implemented a new automation system. Any of these changes can poke holes in your controls environment.

Periodically testing the strength of your internal controls is essential to identify and plug these holes. While internal auditors often perform these tests on a regular basis—especially if your organization is subject to Sarbanes-Oxley—accounts payable departments should also test on their own. Whether done manually or with automation, testing controls is the only way to guarantee they work.

Adequate and Effective?

Internal controls are steps in a process designed to eliminate

the risk of fraud or errors. Controls in your accounts payable process should minimize waste, limit losses, prevent misappropriation, and safeguard your organization's assets.

For a complete description of accounts payable internal controls, see the TAPN feature "Internal Control—Objectives and Implementation."

Simply drafting internal controls around your transaction process does not ensure that they are successful. This is where testing comes in. When developing a new control, be sure to include a procedure and schedule for testing it for adequacy and effectiveness.

According to Mike Iverson, CFO of Financial Operations Networks, a control is adequate if the staff members follow the process outlined in the manual. For example, if your organization has a control requiring a second signature on all checks above \$25,000, the control is adequate if approvers are actually requiring these signatures.

A control's effectiveness refers to how successful it is at preventing fraud or errors. If the staff adheres to a control, then it is adequate. However, if the control does not fully protect the process, then it is not effective.

"If you wanted your staff to require a second signature for checks over \$25,000 and they did that, then the control was followed adequately," Iverson says. "But if you still had fraud because someone printed the check and figured out how to copy the signatures, then by itself it wasn't an effective control."

It is important to test your internal controls both for adequacy and for effectiveness. You want to make sure that employees are following the procedures outlined in your policy manual and that those procedures have the desired results.

Copying From the Auditor's Playbook

Traditionally internal or external auditors have been responsible for testing an organization's internal controls. However, not every organization has an internal audit department and many cannot afford or choose not to hire external auditors. The following are two auditing techniques that AP management can use to evaluate their controls environment:

1) Process Audit

During a process audit, map out the entire process you are testing and then take a 'walkthrough' to determine whether employees are following all of the controls and whether those controls

...continued on pg. 2

Controls continued...

A documentation audit involves looking at several transaction documents to verify that the staff applied the correct controls.



“If every invoice is supposed to be signed off by a manager, we are going to pull some invoices to see if they are actually being signed off.”

are effective. Ask AP staff members to describe in detail their part of the process so that you can make sure their day-to-day responsibilities match what your controls require.

2) Documentation Audit

A documentation audit involves looking at several transaction documents to verify that the staff applied the correct controls.

“If every invoice is supposed to be signed off by a manager, we are going to pull some invoices to see if they are actually being signed off,” Iverson says, describing one type of documentation audit. “If the internal control policy says that every check over \$25,000 requires a signature, we’re going to pull several checks above that amount and see if the control is being adhered to.”

While these are techniques often performed by internal and external auditors, the individuals testing your AP controls could be members of the AP staff, the AP manager, or maybe a manager from another department, if you want someone independent of the process.

The Automated Approach

Testing controls with typical audits can require significant time and effort. For this reason, departments often perform these tests at specified intervals, such as once every year or two. Organizations that want more timely evaluations can use analytic software that allows them to test controls on an ongoing basis.

Called continuous controls monitoring software, these software systems connect to the user’s ERP system and generate reports on a variety of control issues.

For example, many organizations do not allow the same person who enters an invoice to approve it for payment. CCM technology can check the authorization tables within the ERP to determine if any employees can do both.

CCM software can also review transaction logs and look for instances where controls violations might have taken place by checking for warning signs such as:

- Split invoices—large invoices divided into multiple payments to circumvent approval limits

- Price variances—invoice price differs from amount approved for purchase
- Invoices approved by the same person that created the purchase order
- Invoices approved by the same person that created the goods receipt
- Missing/incorrect vendor information—date missing from the vendor master file such as payment terms and tax information
- Duplicate invoices—software looks for minor variances that ERPs might not catch, such as similar invoice amounts from the same vendor or slight changes to the invoice number format

Many organizations justify the expense of implementing CCM thanks to the software’s ability to prevent duplicate payments, in addition to improved transaction control monitoring.

“After using the technology for eight months, we identified \$300,000 in improper payments before they went out the door,” says Brian Anderson, accounts payable manager for Emergency Medical Services Corpora-

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AP Monthly is a publication of The Accounts Payable Network, the complete resource for executives and managers responsible for accounts payable. TAPN provides deep and comprehensive resources to help you meet your accounts payable objectives and challenges.

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In the News

Mileage Rate Increase — Due to a surge in gas prices during the first half of 2011, the IRS has issued a rare mid-year mileage rate update. Beginning July 1, 2011, the standard mileage rates for the business use of a car (including vans, pickups or panel trucks) will be:

- 55.5 cents per mile for business miles driven;
- 23.5 cents per mile driven for medical or moving purposes; and
- 14 cents per mile driven in service of charitable organizations.

IRS mileage rates are the maximum per-mile amount that taxpayers can deduct for business use of a personal vehicle. Many organizations use the standard mileage rate to govern how much they will reimburse employees for business miles driven. ■

Controls continued...

tion, who uses ACL's CCM technology. He adds that his company saw an ROI in less than a year.

Although CCM technology identifies duplicate payments and other lapses in control as soon as they happen, the software typically aggregates violations and presents them to management at predefined intervals.

"Transaction reports are generated after the fact rather than in real-time because there's a reluctance to intervene too much in the actual procure-to-pay process," says John Verver, VP of Services and Product Strategy for ACL. "Typically you receive reports on a daily basis. After all the transactions have been processed, you perform the analysis and identify the exceptions."

Manual Testing Still Important

While automation reduces the burden associated with testing your transaction controls, it does not eliminate the need for manual tests. You cannot test physical controls, such as restricting access to check stock, using technology.

"If someone is supposed to have limited access to the room where check stock is stored, then there is probably a key to the room," Iverson says. "When testing that control, you are going to check with the staff to see who all has access to the room. If there's a keypad, then you have to make sure that the combination is changed whenever an employee is terminated."

Whenever you interview AP staff members about their role in upholding a control, always be mindful of your tone. "Talk to them in a conversational way," Iverson says. "You don't want them to think that you are accusing them of something."

Interviewing the staff to determine their full job descriptions is a good way to check for segregation of duties conflicts. Pay special attention to employees that may have recently transferred jobs. For example, an employee who moved from disbursement processing to invoice processing may still have access to the check-writing system.

"Look at what the individual is supposed to be doing and whether their previ-

ous capabilities have been eliminated," Iverson says. "Now, a lot of this may come back to keeping employees cross trained. But you have to be sure that, depending on the activity, they can only perform it when they are substituting for someone else."

Checking physical safeguards and interviewing employees are essential manual checks that technology cannot perform. According to Verver, even the best CCM can only test about 80 percent of an organization's control, leaving the other 20 percent manual.

When to Test?

Despite the need for strong controls, organizations cannot always test as often as they would like. While Iverson recommends reviewing your internal controls annually, organizations do have other things to worry about. If you cannot test all your controls regularly, consider focusing on key processes and areas where problems have existed in the past.

"If you have had issues, then that should prompt you to test more frequently," Iverson says. "If you've never had an issue, then perhaps not as frequently. It's all driven by the business." ■

TAPN Tools

Internal Control Checklist

When testing your internal controls, you must have a way to identify which are effective and which are not. If a control fails to protect your process, you must also be able to explain why.

TAPN's Internal Control Checklist assists you when reviewing your internal controls. Using this checklist, you can document your controls, the individuals responsible for performing each activity, whether the controls are successful, and identify any actions necessary to correct an ineffective control.

Because no two businesses are alike, it is impossible to create a definitive list of the internal controls all organizations should have in place. However, the checklist features many controls applicable to generic AP departments. There is also room to add controls unique to your organization.

Find this tool in the "Internal Control Manual" section of AP Tools or at www.tapn.com/InternalControls. ■

AP Answers

Q: Does Sarbanes-Oxley provide a detailed guide about what constitutes adequate separation of duties?

A: Sarbanes-Oxley does not address "how to" do separation of duties. Here are a few examples regarding separation of duties:

- Invoice data entry personnel should not have access to set up new vendors in the data base
- Personnel who write the disbursement checks should not be the same personnel who enter the vendor invoices
- Reconciling vendor statements to your accounting records should be separated from personnel who can enter or issue a vendor credit adjustment

Q&A

THE
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NETWORK

Did You Know? *IRS Presumption Rules*

The IRS publishes a series of guidelines, called presumption rules, outlining how to treat payees that fail to provide documentation. Using these rules, payors can determine whether a payee is a U.S. or foreign person and whether they should withhold on any payments. Following these rules will prevent your organization from being liable for your vendor's unpaid taxes, interest and penalties.

Without a valid form W-8 or 8233, the default assumption is that the payee is domestic and subject to information reporting and tax withholding. However, the presumption rules state that you can

treat the vendor as foreign if it meets any of the following conditions:

1. You have actual knowledge of the payee's employer identification number and that number begins with the two digits "98"
2. The address you have on file for the vendor is in a foreign country
3. The payee's name is on the per se list of foreign corporations in Treasury Regulation 301.7701-2
4. You make the payment outside the U.S.

Similarly, when paying an individual for services, the IRS

states that you can presume that the payment is to a foreign person for foreign-source income (not reportable) if it meets all of the following conditions:

- The payee is an individual
- You do not know, or have reason to know, that the payee is a U.S. person
- You do not know, or have reason to know, that the income is effectively connected with a trade or business inside the U.S.
- The payee performed all the services outside the U.S. ■

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To register for this webinar call us at 866-827-6389 or visit us at www.tapn.com/ComplianceWebinar. ■

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To register for this conference, call us at 866-827-6389 or visit us at www.tapn.com/IOFM2011. ■



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