

CHAPTER 4

MANAGING CASH OUTFLOWS

Objectives

After reading this chapter, you will be able to:

- Review how funds in depository and lockbox accounts are brought together through the process of cash concentration.
- Understand disbursement system approaches to sending payments to vendors, employees, and others with the appropriate timing, cost and mechanism.
- Evaluate controls against fraud and other criminal activities in paper-based disbursement systems.
- Learn of new approaches to purchasing and accounts payable cycles.

Introduction

The lockbox system that was implemented was so successful that Bill Fold wonders if changes should be made to the company's concentration and disbursement systems, also managed by Ann I. Shade. Bill is particularly concerned about the external CPA's recent audit comment regarding the national increase in check fraud, and potential problems with the disbursement systems used by GETDOE. In addition, he wonders if there are any possible cost or float savings worth investigating, and if centralizing disbursements might make the entire process more efficient.

The collection activities described in the previous chapter lead to funds in depository and lockbox accounts. These funds must then be mobilized into a central account -- the concentration account -- to fund the outflows that normally arise in business: paying vendors, issuing payroll, reducing loans, and/or investing in interest bearing securities. Concentration and disbursement are both tools designed to minimize idle balances and keep cash constantly at work.

Concentration Systems

Companies with large numbers of geographically dispersed stores, such as retail and fast-food chains, require local depositories to receive checks, currency and credit card receipts (unless transmitted through an in-store modem). As a result, funds often accumulate in collection accounts in various locations. In order to use the funds most effectively, the cash manager needs to concentrate the balances.

Mobilizing Funds

There are a number of options for a company to move funds into the concentration account.

- **Deposit reporting services.** A deposit reporting service (DRS) functions to assist in the mobilization of funds in local accounts to the concentration account. The store manager contacts the DRS through a toll-free telephone number or a point-of-sale (POS) terminal and following a series of prompts, reports the store number, the time and amount of the deposit, and any detail required by the company (such as the coin and currency sub-total). The DRS accumulates all of the calls for the company, creates an ACH file to draw down the deposited funds, and transmits the ACH through the banking system. The all-in daily cost per store is approximately \$1. There are several DRS vendors, including NDC, First Data and ADP.

The effectiveness of a DRS system relies on the store manager reporting accurate and timely information. The company can be notified if any store does not contact the DRS, allowing a rapid follow-up to determine the reason for the failure. However, errors will occur if the manager reports a deposit that is not made; a deposit is made after the local bank's cutoff time for ledger credit; or if the amount reported varies from the actual deposit. The result can be overdrafts at the local bank from which the deposits have been concentrated, which can cost \$25 in fees for each occurrence.

- **Company-initiated concentration.** Large companies with widespread local offices or stores may develop their own concentration reporting systems. The technology used often involves minicomputer processing, with automated notification by the local site to a treasury function using specified protocols. For example, the stock brokerage industry uses proprietary systems to report each day's activity at branches, details of which include:
 - Checks and securities received by client account
 - Local, national account, and cashier's checks written to pay out funds
 - The amount and time of the deposit
 - Other transactions

Some of these systems require the branch to input the transit routing numbers of client checks (see Chapter 3) to determine when good funds will be received at the local depository for inclusion in the concentration amount. Treasury prepares the concentration wire transfer or ACHs, based on a cost-benefit calculation for each method.

- **Standing instructions.** The administrative effort necessary to concentrate funds can be alleviated by the issuance of standing instructions to the depository or

concentration banks to effect transfers based on various criteria. The criteria could be based on:

- Frequency: for example, daily or whenever a "trigger" occurs, usually defined as a collected funds threshold
- Amount: for example, any collected funds or only funds exceeding a predetermined target
- Mechanism: for example, ACHs for small amounts and Fedwire for large sums as determined by the company's analysis

Smaller depository banks may not be able to handle such guidelines. In those situations, the concentration bank can initiate a reverse (or drawdown) ACH or Fedwire based on instructions from the DRS or the company.

- Zero balance accounts (ZBA): The ZBA structure is used to minimize idle balances in a DDA account. It is an automated service that is used for both the concentration of balances and the funding of disbursement accounts. A master concentration account withdraws any residual balances in individual collection accounts within the same bank network, based on the account holder's standing instructions. The funds can then be used for investment or disbursement purposes.

Concentration System Considerations

Design of a cash concentration system involves consideration of cost and access to information. There are three *cost* elements to examine in planning a concentration system:

1. The cost of the transfer mechanism. Electronic funds transfer systems are discussed in Chapter 2. As was noted, there is a significant cost difference between Fedwires and ACH transfers. A Fedwire costs approximately \$10 to 15 for a wire out/wire in from the collection account to the concentration account. An ACH transfer is usually about 15 cents for this same journey. However, it should be noted that costs vary fairly widely for these activities, depending on the extent of automation in ordering the transfer and pricing by individual banks.
2. The value of the funds in the bank. Cash sitting in collection and concentration accounts incur an opportunity cost in that there may be more productive uses for the funds. Some companies establish tiered concentration systems, which use multiple levels of concentration accounts to support different corporate businesses. However, any cash in these accounts is earning only a nominal earnings credit rate (ECR), discussed in Chapter 8, which may be several percentage points less than the company's cost of capital.
3. The opportunity cost of local accounts. Depository accounts are often used to support the cash requirements of a branch office or other activity distant from corporate headquarters. It may be necessary to leave balances (sometimes called

"target balances") in the accounts for such uses as paying local invoices, emergency disbursements, check encashment, compensation to the bank for its services, or other needs. There is an opportunity cost for these balances, which may be substantial if a company has dozens of local accounts.

The amount of the funds in the collection account should be evaluated to determine if it is cost effective to use Fedwire (a same –day mechanism) or next-day ACH in order to invest, cover disbursements, or reduce loan balances. For example, \$250,000 in a collection account may reduce a loan balance carrying a cost of 10%. The value of this amount in repaying the loan for one business day is \$100 ($\$250,000 / 250 \text{ business days} \times 10\%$). If left on deposit in the collection account at an assumed ECR of 2.5%, that amount would earn \$25 ($\$250,000 / 250 \text{ business days} \times 2.5\%$). Assuming a Fedwire charge of \$15 the company would earn an incremental \$60 ($\$100 - \$25 - \15) by making a wire transfer of the collection balance.

Access to information relates to the knowledge that treasury staff has of daily collection balances in depository accounts. Large, decentralized businesses with many local accounts often will not have accurate data on daily receipts and deposits. Smaller companies with fewer sites can more easily exchange information about sales activities and local disbursements through e-mail or telephone. The cash manager must weigh the complexity and cost of the system, the burden placed on the local office manager responsible for the deposit and for notifying home office, and the value of the funds transfers in developing the optimal design.

Tips and Techniques

There is no longer any compelling reason for most companies to use extensive networks of banks for cash management. The trend toward bank consolidation (discussed in Chapters 8 and 10) permits fairly broad national coverage through one or two financial institutions. Interstate branching will eliminate or reduce the need to concentrate funds to the extent that collections can be channeled through a single bank.

Disbursement Systems

A *disbursement* system pays vendors, employees, tax agencies, bond and stockholders, and other payees at the proper time using the appropriate mechanism. As with paper collections, a disbursement system must be managed to reduce idle balances while providing timely disbursement information. Disbursement float arises from the time a check is issued until funds are debited to the payor's account; see Exhibit 4.1.

[Insert Exhibit 4.1 here]

Mail and clearing float were major considerations in the past when designing a disbursement system, and companies often used remote country points to extend

disbursement float. Most companies today are reluctant to send checks from locations distant from their office sites out of concern for the appearance of improper behavior.

Businesses have a number of options in establishing disbursement facilities as discussed in the following pages.

Regular Checking

A regular checking account may be established at any commercial bank, and is similar to personal checking used by households. These accounts receive activity during the bank's normal business hours, which effectively means that any holder of a check can request funds from the account (or "cash" the check) at any time; also known as an over-the-counter presentment. The owner of the account must arrange to either leave balances or transfer funds into the account to cover such activity, or risk the expenses and embarrassment associated with having a check returned for non-sufficient funds (NSF). A good forecasting system can help reduce the level of balances maintained in disbursement accounts; see Chapter 5.

Zero Balance Accounts.

As was noted in regard to concentration, a ZBA used for disbursements seeks to minimize idle balances in a DDA account. A master account funds the disbursement accounts that have experienced clearings during the day. The net effect is that, at the end of each business day, the balance in each individual account is restored to zero.

The ZBA reduces the number of funding transactions and minimizes funds held in the account(s) awaiting the check clearing process. The issuing company then funds the master account with a Fedwire, or an intrabank transfer. This arrangement is often used when companies need to segregate disbursement accounts for accounting reasons.

However, the ZBA approach has one significant disadvantage. Check clearing information is usually not available until the next morning, after the bank has run its DDA system overnight. This procedure results in underutilized funds retained in a bank account to cover clearing checks, or in an overdraft if the required balances are miscalculated.

Controlled Disbursement

In 1983, the Fed established payor bank services, which provides participating banks with information on presentments to be made that day, very early in the morning. This permitted banks to develop *controlled disbursement* accounts, a specialized form of ZBA account used only for disbursements. The controlled disbursement account is funded once, in the morning, to cover the daily check presentments, this procedure eliminates the need for companies to leave balances to cover clearing items. Early notification of checks clearing that day allows funding of the account on a same-day basis, and helps the cash manager determine the company's cash position.

These accounts are established in RCPCs (regional check processing centers) or country points to which the Federal Reserve delivers the clearing checks (or cash letter or a data file of clearing items) in the early morning. Banks with more than \$10 million in average daily clearings from banks outside their Fed district receive a second presentment from the Fed through the High Dollar Group Sort (HDGS). As the result, these banks provide two clearing notifications to issuing companies:

- The 1st presentment amount, available by about 8:30 a.m., normally covers some 75% of the total day's debit
- The 2nd presentment amount, available by 10:00 a.m., contains all of that day's clearing dollars

The impact of disbursing through a bank with a 2nd presentment is that the cash position is not known until much later in the day and is, therefore, of little help to the cash manager in determining the daily cash position. HDGS is intended to discourage disbursing from a geographically remote location. See Exhibit 4.2 for a current list of banks and their controlled disbursement locations.

EXHIBIT 4.2
Controlled Disbursement Sites

Bank	Locations	
ABN AMRO - LaSalle	Chicago RCPC	
Allfirst Bank	Millsboro DE	Vandalia MO
AmSouth Bank	Jasper AL	Walnut Creek CA
Bank of America	Asheville NC	Wichita Falls TX
	DeKalb GA	
	Northbrook IL	Wilmington DE
	Tallahassee FL	Wewoka OK
Bank of New York	White Plains NY	Port Arthur TX
Bank of Oklahoma	Henrietta OK	Wilmington DE
Bank One	Circleville OH	
	Dearborn MI	
	Evanston IN	
Citibank	Wilmington DE	
Comerica Bank	Ann Arbor MI	Wilmington DE
Deutsche Bank	Wilmington DE	Wausau WI
First Union	Chapel Hill NC	
Firstar Bank	Memphis MO	Portland ME
	Miamisburg OH	
Fleet	Hartford CT	Wilmington DE
Harris Bank	Roselle IL	
JPMorgan	San Angelo TX	Price UT
	Syracuse NY	Vermilion OH
KeyBank	Albany NY	
	Anchorage AK	Wilkes-Barre PA
	Portland ME	
M & T Bank	Ithaca NY	Pittsburgh RCPC
	Newburgh NY	
Mellon Bank	Medford MA	
National City Bank	Ashland OH	
Northern Trust	DuPage IL	Sevierville TN
PNC Bank	Jeannette PA	Havre MT
SunTrust Banks	Rome GA	
U.S. Bancorp	Aspen CO	New Holland IL
	East Grand Forks MN	Winston-Salem NC
Union Planters Bank	Goreville IL	
Wachovia Bank	Augusta GA	Plano TX
	Greenville SC	Van Wert OH
Wells Fargo Bank	Calabassas CA	
	Grand Junction CO	
	Lewistown MT	

Source: Reported on the Phoenix-Hecht Web site, www.phoenixhecht.com, January 2002.

The relative inaccessibility of these locations minimizes the possibility of an over-the-counter presentment during the day. Most banks offering controlled disbursement will hold any checks so received, or will make clearing adjustments the next day for debit to the account, eliminating supplemental funds transfers to cover any shortfall.

There are several features of controlled disbursement that provide advantages for the check issuance and funding process. In addition, various control and reconciliation products support controlled disbursement to minimize potential occurrences of fraud or accounting mistakes. Each of these will be discussed in the sections that follow.

In the Real World

Banks establish their controlled disbursement sites at locations that are difficult to reach and are only served by the Federal Reserve check clearing system. Consequently, float can be extended (by 1/4th to 1/3rd of a business day according to Phoenix-Hecht studies) by using these relatively inaccessible sites. Although the lengthening of clearing float through a controlled disbursement account is feasible, the finance profession and the Federal Reserve have long-established policies against the appearance of disbursing “remotely” to gain float.

Unless a company is located in a remote location, such as Montana, Utah and Colorado, the intention of extending float will be fairly obvious to check recipients. The ill will that may result is probably not worth the slight float gain, and it is generally not recommended. A better alternative is simply to diary payments for one additional day but use a bank located in the company’s state of domicile.

Funding

A major advantage of controlled disbursement is a morning notification by the bank of the clearing total from the Federal Reserve’s cash letter presentment. The bank notifies the company electronically at about 10 a.m. (local time) based on the information transmitted through payor bank services without waiting for the delivery of checks – the cash letter -- to arrive. This information is available to the company through various mechanisms, including telephone, fax, and the bank's computerized information reporting system. The company then has until a specified time later in the day (usually the close of business) to fund the resulting debit.

Funding options include intrabank transfer, a wire transfer from the company’s concentration bank, or an ACH credit. The ACH credit does not become good funds until the next business day, so the controlled disbursement bank will require the equivalent of the average check clearings of one or more days to be maintained in the account to cover the ACH float.

Positive Pay

Positive pay is the most important control and fraud prevention concept available for checks. After each day's check run, the company sends a file to its bank containing data on all issued items. The issued file is delivered by magnetic tape or through a PC modem transmission. The bank merges the daily file with data on all previously issued checks that have not yet been presented for clearing. When the cash letter arrives at the bank the following morning, clearing items are matched against issued items.

Positive Pay and Fraud Prevention

Mismatches of clearing and issued items by check number and dollar amount are reported to the company through the bank's computerized reporting system. The company has a period of time (usually about 4 or 5 hours) to decide whether to authorize or reject the payment of each item. Manual reconciliation, discussed in the next section, can detect a fraud, but on a seriously time-delayed basis. Positive pay attacks the problem each day as checks clear against the bank, offering a first line of defense against a fraudulent check.

With the FBI estimating the extent of fraud at \$5 to \$10 billion a year in the U.S., banks have begun to insist that businesses using their disbursement products accept positive pay. This is accomplished in two ways:

- Consistent with UCC4A provisions (discussed in Chapter 8), some banks will not accept any liability for fraudulent checks unless positive pay service is used.
- Other banks are now pricing disbursement services to include positive pay with controlled disbursement rather than as a separate service.

The most common reasons legitimate checks are not included in the issued file are emergencies that occur after the regular check run or as disbursements from branch locations. In those situations, the data from those checks should be entered into the next daily positive pay file transmission. Should that not occur, a "mismatch" will result. The other cause of a mismatch is an attempted fraud, such as when a legitimate check is altered for a larger sum or a completely counterfeit check is created using invalid check numbers and dollar amounts.

When the company receives notification of any mismatches, it should research each item to determine whether the cause was innocent or an attempt at fraud. This requires determining who authorized the check, what the purpose of the payment was, and whether a crime may be occurring. The bank will need a decision before the Fed deadlines so that it can return any rejected checks through the banking system. To protect itself, the bank will require a default decision of "pay" or "don't pay" at the time that the service is established.

In the Real World

Positive pay may not be able to prevent a fraudulent check from being cashed at a bank teller line since only a few banks currently have teller on-line access to the issue file. The best interim protection is to work with the banks to develop a program assuring positive identification for check cashing, including photo identification and two other proofs of identity. In addition, positive pay cannot catch a counterfeit endorsement or prevent encashment of a fraudulent item in good faith by a check cashing exchange.

Other Disbursement Services

Reconciliation

Monthly reconciliation is necessary to determine that the bank's records and company ledgers are in agreement, and that neither party has made an error that goes uncorrected. In fact, UCC Article 4 (see chapter 8) requires that companies examine bank statements within a reasonable time frame, not to exceed 30 days after the statement has been sent, and to report to the bank any unauthorized signatures or alterations.

Companies typically receive bank statements about 15 days after the end of the month, including cancelled checks and advices of other debits or credits. Reconciliation clerks add any deposits made after the statement closing date to the banks ending balance, subtract the total of any checks still outstanding, and make any necessary correcting entries to make the bank and company ledgers balance. This process should spot any fraud, but a month or more might pass before an investigation begins.

Banks can now provide automated partial or full reconciliation to the company within 5 to 10 days of month-end. Partial reconciliation (or "recon") is simply a list of paid or cleared items, including check number and dollar amount that the company must then reconcile against its own ledgers. Full recon involves a matching of issued and clearing items by the bank, with reports on items:

- Issued and paid (or cleared)
- Issued but not yet paid
- Paid but not issued: that is, which were not entered on the daily issued file
- Force posted: items which involve duplicate check numbers due to check printing errors or fraud

Full recon is typically provided in a positive pay environment because the bank already has the issued file and needs no further input.

In the Real World

Manual reconciliation has generally been an imperfect mechanism to detect fraud. In one situation, a company issued a legitimate payment for \$80. The check was altered to

\$8,000 by adding two zeros, and presented for payment. Four months passed by the time the recon clerks discovered the fraud. Investigators could find no trace of the criminal responsible and the company had to accept the \$7,720 loss.

Stop Pays

A company may determine that a check was issued in error or as a duplicate payment. The check can be “stopped” or prevented from being honored by the bank through the issuance of instructions directing that the item be rejected if presented for clearing. Stops can be initiated through the bank’s electronic banking platform, by telephone or fax. Stop payments typically are valid for six months and must be renewed thereafter.

Check Safekeeping

Banks will store cancelled checks on their premises for 60 to 90 days, and then create copies of each check (front and back) in microfilm, microfiche or imaging technology. The copy can be provided to the company for research in the form of film, fiche or CD-ROM. Alternatively, the bank will store and reproduce the check copy for a fee if so directed. Courts now accept check copies as proof of a payment or in fraud investigations, allowing the destruction of the paper item.

Check Fraud Prevention

While positive pay has significantly reduced the incidence of check fraud, disbursement systems have numerous other potential areas for criminal attack. Other actions to reduce fraud include the following (in sequence order):

Prior to Issuance

- Secure check stock and signature plates, and only allow authorized staff to have access to the treasury locations where they are stored. Maintain logs of use including check number runs.
- Verify vendors used in the purchasing – accounts payable cycle. Fraud may occur in purchasing through the use of fictitious vendors. Vendors should be reviewed for legitimacy by the following actions:
 - Require a federal tax identification number
 - Conduct a credit check on the vendor using a credit agency
 - Obtain an audited financial statement
 - Visit the vendor’s premises
 - Request references from other customers

Issuance

- Print checks on blank safety paper using laser check-printing equipment. Rather than signing checks by signature plate, print the signature or a substitute at the time the check is printed. Substitutes for signatures include unique characters, Greek letters or other typographical marks.
- Consolidate check issuance, and close local accounts opened for the convenience of branch expenses. All checks should be issued from a central site under the supervision of designated employees.

Post Issuance

- Keep all checks in a secure area within treasury. Do not allow company employees to pick-up checks for individual transmittal, and do not allow vendors to stop by for hand delivery of payments.
- Review all positive pay mismatches to ascertain that approved items are legitimate payments and not attempts at fraud.

Policies and Procedures

- Work with local banks to prevent check fraud. Insist that checks presented for payment are supported by multiple identifications, including a driver's license, a credit card and if the check is for payroll, an employee photo ID.
- Limit authorized signers to a few senior corporate officers. A company with numerous branch locations can have hundreds of authorized check signers. Although banks do not verify signatures except when checks are deposited through a teller, controls on approved signers can improve the possibility of preventing or proving a fraud.
- Separate the function of maintaining the approved vendor file from other activities, and do not allow vendors to be added by purchasing clerks.

Electronic Check Presentment

Certain banking institutions use electronic check presentment (ECP) to reduce the risk of fraud. The depository bank captures the MICR line from the check and transmits it electronically to the drawee bank. The drawee bank can then review checks issued file and determine if any item is a mismatch one or two days before the paper check clears. (The actual check clearing process is based on the paper check, not the ECP). Checks transmitted through ECP constitute less than 5% of all check volume, with the Fed handling about three-quarters of all ECP volume. (The governing organization is ECCHO, whose Web site is located at www.eccho.com.)

A related program is check truncation, where the paper item is not returned to the issuing company and all funding and reconciliation is from the MICR line data. Typically,

a copy of the check is captured through imaging, which is then provided through a CD-ROM, paper or an Internet download.

Payroll

The payment of wages and salary has gradually migrated to direct deposit by ACH electronic transfers, although many payrolls support both direct deposit and checks. The usage of electronic transfers is probably one-half of all payroll transactions, but exceeds 80% in California and certain other locations.

Direct Deposit Mechanics

The employee provides a voided check from his or her bank account to the payroll department. TRN data (see Chapter 3) from the bottom of the check is used to build a file record of the bank address, the account number, and the net amount to be paid. Depending on the arrangement with the disbursement bank, the ACH transfer is made one or two days before the pay date. This assures that good funds will be in the employee's account on pay date.

The primary advantages of this process are:

- Lower cost to the employer, in that the cost of an ACH is about 10% or less of the all-in cost of a check.
- Reduced employee absence, as there is no reason for the employee to leave company premises to deposit or cash the payroll check.
- Convenience for the employee, as the pay is in the bank regardless of weather, vacation, business travel or the loss of the payroll envelope.
- Fraud prevention, as there is no need to verify the identification of an employee attempting to cash a payroll check.

Disadvantages include the following:

- The employer loses all use of the funds deposited for the payroll -- the float -- on pay date. Studies of payroll check clearing show that the average delay in check clearing is about 3 business days. The value of this float loss could be considerable; for example, a \$500,000 weekly payroll would cost about \$30,000 a year in lost float if entirely converted to direct deposit ($\$500,000 \times 10\% \div 5 \text{ days} \times 3 \text{ days}$).
- The funds are credited to the employee's account, the earnings on which, depending on the type of account, may or may not accrue to his or her benefit.

- The employer must manage a dual payroll system – check and direct deposit – unless all pays are converted to electronic. This is not a major concern for most companies because a payroll services vendor is often used for payrolls. Leading companies include ADP, Interpay and Paychex.

In the Real World

Employees who resist direct deposit typically want to hide pay from a spouse or significant other, do not have a bank account, or are simply uninformed about the mechanics of the program. Companies can require direct deposit as a condition of employment, but must allow employees to select the financial institution to which their pay is sent.

Educational programs conducted by human resources or a local bank may help to overcome resistance. Many companies find that a bank is only too happy to market their services to a new audience through a year's free checking, discounted mortgage or home loans, free credit card programs, or other promotions.

If there is sufficient employment at a single site, the bank may be willing to install an ATM for employee banking (which the company may have to subsidize). A collateral advantage is eliminating petty cash maintained to accommodate check cashing and travel or expense reimbursement. In addition to the management and replenishment of these funds, the company avoids the risk of theft.

Paycards

For employees not wishing to receive a check (because of problems of encashment or security), several banks offer payroll ATM cards. The employee need not have an account at the payroll bank. Instead, an ATM card is issued along with a PIN number, allowing access through any ATM machine or at merchants that accept the card family (i.e., Visa or MasterCard). The employee receives a monthly statement detailing withdrawals, payroll credits and purchases.

Purchasing – Accounts Payable

The purchasing - accounts payable cycle involves extensive paperwork, including requisitions, purchase orders, receiving reports, and payment approvals. This process has been estimated to cost in excess of \$100 per transaction. To avoid this cost (except for sophisticated and technical purchases), several banks and credit card issuers now offer procurement cards.

Procurement Cards

Procurement cards (also known as purchasing cards) are essentially like corporate credit or debit cards that are issued to designated employees to make purchases on behalf of the company. However, they differ in the following respects:

- The company receives the bill and is responsible for payment
- Codes are imbedded in the card to restrict purchases to eligible types of products and services, and to limit the total amount spent
- Automated data capture enables the company to receive next-day summaries of purchasing activities

Purchasing can be simplified through the use of the cards for routine items. A major procurement card benefit is the elimination of the paperwork inherent in creating a purchase order (sometimes called a PO). In addition, volume discounts may be arranged with vendors frequently used, and employees can be encouraged or instructed to use those suppliers.

Savings arising from procurement card programs can be 80% to 90% of the cost of the traditional purchase order cycle. In establishing the program, companies frequently develop efficiencies through the reengineering of elements of the purchasing/accounts payable cycle. Opposition has been primarily from purchasing departments who see these cards as a threat to their position in the company. However, widespread card usage has minimized this problem, particularly as management is generally pleased with the savings typically achieved.

Tips and Techniques

Some companies have overcome opposition to procurement card programs by emphasizing the advantage of the elimination of routine buying from purchasing department processing. With middle managers deciding on basic purchases, purchasing professionals can spend their time on procurement decisions requiring technological, systems, and engineering expertise.

Other Potential Improvements

The purchasing – accounts payable disbursement cycle offers various other opportunities for efficiencies.

- Cash discounts. The lengthy payables cycle for items acquired through purchase orders requires a match against receiving reports (sometimes called receivers) prior to the approval for payment. A review of this process may reveal missed cash discount opportunities when vendor invoices are not paid within the discount period, often 10 days from the receipt of the invoice (as in 2/10, net 30).
- Early release of payments. Some invoices are paid early, before the stated date on the invoice or the date established by company policy. This often results from a “clean desk” policy, where companies require paperwork to be “cleared” from work areas as soon as all documentation is compiled, regardless of time value of money considerations (see Chapter 1). Payments should not be released prior to the date established by vendor terms (i.e., net 30 days) or by company policy

(i.e., no payment will be issued before 35 days have passed since the invoice was received).

In the Real World

Early payments – that is, before the established due date – are often made to important vendors who seek preferential treatment by the payables staff. In some cases, the amounts involved constitute some of the largest purchases regularly remitted by a company. Computer salesmen have been known to pick up checks in person, rather than wait for the check printing - mailing cycle. In one situation, an analysis of the accounts payable function found that the average early payment was made on day 22, 8 days before the date stated on the invoice (day 30). This resulted in an annual opportunity cost of about \$60,000.

- Missing Documentation. Vendor invoices are frequently not completely reviewed, in contradiction to basic control procedures. Accounting codes and authorized signatures may not be verified, and the necessary documentation in support of the payment is often missing.
 - Accounting codes are used both to debit budgets for expenditures and to assure that spending has not exceeded approved limits.
 - Authorized signatures are necessary to assure that the requested payment has been reviewed at the appropriate management level. Payables departments cannot be expected to validate hundreds of signatures, some of which are illegible. It is good practice to periodically purge the list of accepted signers.
 - Supporting documentation should include POs, receivers, and vendor contracts, and any payment request missing such reports should be rejected

Tips and Techniques

Managers should not be given blanket authority to approve any type of company expense. The following language in policy and procedures manuals has actually been used: "... company officers with the rank of vice president or above may approve a check request in any amount". This mandate could result in inappropriate (and potentially embarrassing or even fraudulent) expenditures not related to the business purpose of the organization. However, the accounts payable function would be powerless to intervene.

Comprehensive Payables

Several banks offer a complete disbursement outsourcing service often referred to as “comprehensive payables”. The company prepares a file in any of several formats containing the following payment data:

- Due date of payment (as payments can be warehoused by the bank)
- Dollar amount
- Payee and payee’s address
- Mechanism, i.e., check, Fedwire, ACH or EDI
- Accompanying remittance detail

The bank creates payments as instructed and issues them on a date specified by the company. Some banks determine the appropriate payment mechanism based on company-determined parameters. Electronic payments are issued as requested by the company, and are charged based on the bank’s standard pricing.

Payments by Check

Checks are prepared for mailing, including any remittance detail required by the issuer. Information typically provides invoice or items number(s) being paid and adjustments to the invoiced amount, including discounts taken or credits for damaged merchandise. Certain industries require lengthy descriptions of payments, such as “explanation of benefits” (EOB) statements provided to insureds and healthcare providers by insurance companies.

Most comprehensive payables banks can process all of this material, including the envelope. The bank can also print company logos, signature lines, and promotional statements, such as “ask us about e-commerce”. Inexpensive desktop technology allows the issuance of emergency checks and the transmission of a supplemental issued file to the bank.

The payment is prepared for delivery; postage is applied, and mailed. The bank will attempt to gain the highest postal discount offered by the USPS for quantity mailings, currently 4.5 cents (as of early 2002). As the checks clear, the bank performs the usual positive pay service, and funds the resulting daily debit based on instructions from the company. In addition, reconciliation and check storage is provided.

Benefits

There are significant benefits to companies using the comprehensive payables service.

- Consolidation of the payments function. Instead of having to maintain different systems for the different payment types, companies can now use a single file and system for all disbursements.
- Outsourcing the entire check printing/ mailing/ reconciliation process. Several internal company responsibilities can be entirely eliminated, and the risk of

internal fraud is significantly diminished with the handover of the process to a bank.

- Cost savings. Studies indicate that the all-in cost of creating and sending a payment is approximately \$5, although fees vary by issuing organization. Banks are currently bidding the service for about 50 cents plus postage for paper disbursements. Electronic disbursements are charged at the bank's price for ACH, EDI or Fedwire, with an additional charge for managing the disbursement process. The company continues to have some expenses for general bank contact, including overall supervision and the daily "pay" or "no pay" positive pay decision. A rough estimate of the cost of using a bank for outsourced payments is \$1 per transaction.

Summary

Concentration systems are designed to mobilize cash in bank accounts for the benefit of the business: to fund disbursements, repay loans, or invest. However, funds mobilization is undergoing significant changes with the Interstate Banking and Branching Efficiency Act (see Chapter 8) making it possible to concentrate funds in one step by collecting through the branches of a single bank network.

Appropriate disbursement mechanisms must be selected for the entire disbursement cycle – purchasing, accounts payable, and payment issuance – in the context of cost, convenience, control over possible fraud, and access to bank systems. The outsourcing of portions of the disbursement process has become a viable and economic alternative to the traditional check-writing function. The transformation of disbursement systems from paper to electronic is occurring, although somewhat slowly, with the most notable use being the direct deposit of payroll.

After hearing a presentation from their bankers, Ann and Bob realized the extent of their exposure to fraud by not using positive pay. They also became aware of the inherent inefficiencies of their decentralized disbursement system. Of the 5,000 disbursement checks issued each year, about half were to vendors with the other half for payroll. While some direct deposit was used, efforts to encourage greater acceptance had been nominal. As the result of their analysis, Ann and Bob resolved to:

- Consolidate concentration banks to a single bank network. This action would remove idle balances in collection accounts, reduce the volume of funds transfers, eliminate some bank fees, and strengthen credit and cash management links to one financial institution.
- Actively promote direct deposit (in cooperation with the Payroll Department). This would reduce the number of check issued, the check reconciliation burden, and the risk of the theft or loss of a pay check, and provide a convenience to their employees. One of their banks agreed to provide 6 months of free checking for any employee who signed up for the service.

- Implement positive pay and full reconciliation. Besides pleasing their auditors with the heightened control and fraud prevention, positive pay would actually reduce the per check charge from 15 cents to 9 cents. Full recon would eliminate the need for three accounting clerks whose job was to perform the monthly reconciliations.
- Centralize disbursements. Decentralized check writing requires the maintenance of checkbooks at 12 locations, significant costs in maintaining balances in local bank accounts, and delayed notification to treasury of checks written. Centralizing this function would reduce costs, improve controls, and increase the timeliness of accounting.

Although intrigued with the comprehensive payables product, Bob realized that centralization of the disbursement function is a necessary first step before comprehensive payables can be considered.