Prioritizing Payables

How AP Segmentation Refocuses AP Management to Increase Control, Reduce Costs, Minimize Errors, and Strengthen Financial Control

Executive Summary

Successful businesses understand the Pareto Principle, also known as the "80/20 rule" or the "law of the vital few." Effective marketing organizations, for instance, have become experts at focusing their attention and resources on their most profitable customers. Yet when it comes to business operations in finance and accounting, most companies give little, if any, thought to this rule.

In the case of Accounts Payable (AP), most businesses don't handle high-value invoices differently than routine payables—mainly because they don't recognize what invoices are high-value or don't have a process to treat them with priority.

Instead, the conventional thinking in payables processing is that an invoice is just an invoice, regardless of its possible impact on the bottom line. As a result, many organizations miss an important opportunity to minimize cost and maximize revenue. They don't focus on invoices that matter most, resulting in higher costs due to pricing errors, fraud, late penalties, and the inability to identify maverick spending. Handling all AP the same—the "big bucket" approach—creates a cascading effect that leads to inadequate operational control, inefficient business processes, and perhaps most critical, excessive transaction costs. In fact, lagging companies pay over $58 to process an invoice, versus just $1.50 to $2.00 for best-in-class firms.

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There is a better way. AP Segmentation is an approach that involves separating and prioritizing invoices based on their type, characteristics and level of importance. AP Segmentation is also the process by which companies consistently identify "Critical AP"—the 20 percent of payables that are most strategic or problematic to the operation of the business.

This approach creates tremendous opportunity for reduced costs and increased control. Organizations that focus available resources on the most troublesome and essential segments of accounts payable stand the most to gain from automation and overall process improvement.

The proactive review and handling of critical invoices made possible by AP Segmentation strengthens the enterprise's spend management process. The approach helps companies identify pricing errors, uncover potential fraud and maverick spending, and enhance operational control and compliance.

Perhaps most significant for time- and resource-strapped companies, gaining significant return on investment by improving the AP process does not require an "all or nothing" approach. As the Pareto Principle illustrates, a business can take action regarding the relatively small portion of its invoices that are presenting the most problems or having the largest impact; action that will improve the treatment of those invoices as well as the key performance indicators (KPIs) related to the payment cycle.

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This paper will help you understand:

- the consequences of an informal approach to AP.
- why AP Segmentation is the foundation for addressing existing AP.
- challenges and increasing the efficiency of the finance organization.
- five steps to success in AP Segmentation.

Market Drivers: New Goals, New Technology

Why are companies beginning to view AP differently as it relates to their approach and handling of vendors, invoices, and payments? After all, the basic flow of handling AP (invoice receipt, approval and inquiry, validation and reconciliation, and settlement) has remained the same. Of course, not every company performs the AP process effectively.

However, there have been changes in the marketplace and business environment that have caused companies to overcome their inertia and target the AP process for optimization.

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Among the key drivers of change:

A push for greater efficiency in the finance organization. Simply put, companies are looking to do more with less and be more efficient throughout their operations. Accounts payable can no longer resist this momentum. Whether they have a staff of two or two hundred, organizations are constantly asking more of the AP function, with the expectation that it will deliver positive results while using minimal resources and at a minimal cost.

Rising demands for financial compliance. In an era of increasing regulation and accountability, the need for greater transparency and control in the AP process continues to grow. Industry best practices similarly drive the need for documentation of the AP process.

Additionally, increased scrutiny of business relationships means companies can no longer deliver payments a few days late. In many sectors, previous leeway for late invoice payments is gone and companies risk losing essential services or materials if they do not pay invoices on time and within terms.

New accounting technologies introduced. A growing network of AP solution providers has caused companies to realize there are better ways to handle AP than a paper-intensive, manual approach. Also, companies are facing competitive pressure from peers that have adopted AP automation. No one wants to be a laggard.

The technology trickle-down effect. Automation in other areas of the organization has exposed companies' weaknesses in AP. Unfortunately, the implementation of major ERP software over the past 5-10 years has not transformed the AP function in the ways that many had hoped. There are still manual processes, limited workflow, and difficulty meeting compliance criteria. Now, the same executives who authorized yesterday's ERP budgets are taking a closer look at payables, asking how they can improve AP—without making massive cost and time investments—by capitalizing on existing investments and through third-party software additions.

AP's rising visibility as a strategic asset. Many organizations increasingly recognize the vital role of AP in a networked and collaborative economy. *"The department has ceased to be seen purely as a cost center and is now considered a strategic asset,"* according to IOMA Research. *"Senior management now looks to AP to strengthen relationships with suppliers, as a tool to enhance employee satisfaction and as a rich source of cost savings."*

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The Costs of Inadequate AP

A combination of external market drivers and internal strategic goals has created the need for a more sophisticated AP process. Unfortunately, achieving this sophistication runs counter to the process commonly in place.

To most companies, bills are bills, and they all generally get paid the same way. Or, organizations take an informal approach to segmentation, with various finance managers reviewing invoices and applying different processes, based on different standards, to each. Oftentimes, the "squeaky wheel" approach applies, with whoever is yelling the loudest getting paid first. Unfortunately, these informal and unsophisticated processes create a number of problems.

Excessive transaction costs and payment errors. Laggards incur higher invoice processing costs—the additional $56 per invoice that laggards spend versus best-in-class companies, as previously cited. They also have a higher incidence of payment penalties, late payments, and erroneous invoice payments.

Lack of control. 69% of companies report having limited to no visibility into their spending.3 Laggards may simply not know what gets paid or when. This makes them vulnerable to fraud, maverick spending and the aforementioned payment errors because they don't have control over their AP data.4 Additionally, a lack of proper controls and transparency often increases exposure to fiscal liability, something today's organizations are wise to mitigate in the face of new corporate governance practices and standards.

Process inefficiency. The "big bucket" approach to AP leads to longer process cycle times and inefficient payment processes. Companies without efficient processes also take significantly longer to respond to inquiries. Laggards spend nearly 60% more in resources responding to AP inquires than best-in-class companies, and take nearly twice as long to process an invoice and schedule a payment.

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Dumping the big bucket and prioritizing payables

Businesses struggling with the costs of inadequate AP processing must realize a fundamental fact as they try to improve the process: invoices vary. Therefore, invoices should receive variable treatment—including how they are reviewed, approved, and paid—based on their type and characteristics such as vendor, timing, project, demographics, or other criteria. Equally important, this process should be standardized to eliminate manager-by-manager and department-by-department differences that cost money, cause compliance headaches, and damage business relationships.

An organization may want to identify invoices that require no review. It may choose to separate out those that require a more extensive review or approval by multiple managers. Or it may simply need to monitor key performance variables in the AP process by focusing on invoice type.

AP Segmentation is the process of separating invoices into categories. Among those categories will be the 20% of invoices that cause 80% of the problems when not handled properly. This typically includes anything that may impact revenue, drive up costs or create excessive liability or risk. Think of that 20 percent as the company's "Critical AP."

AP Segmentation is therefore the key strategy for avoiding mismanagement of Critical AP and for enabling companies to focus their resources on the highest-value invoices. For instance, AP

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Segmentation might be related to invoice type such as:

+ **Capital or project-related invoices.** Many companies can benefit from the ability to manage invoices associated with a capital allocation, special project, business unit, or physical location.

+ **Tax bills.** These invoices often require a fast turnaround to avoid late penalties, yet are difficult to marshal through the traditional AP process quickly.

+ **Consulting and contractor fees.** Many companies believe that professional services and contractor fees are growing out of control and target this segment for special analysis.

+ **Telecom services.** Industry consolidation has emboldened the remaining carriers to establish practices for more aggressive receivables management, and businesses risk loss of telecom services if this AP segment is not handled appropriately.

Alternatively, AP Segmentation can revolve around the strategic level of one's suppliers and partners or the level of cost and liability presented by certain types of payables. The point is that all payables are not created equal. So why not simply automate the existing AP process?

Companies with a big bucket of invoices and a limited amount of human resources to process them often set their sights first on automation. Also, with over 80% of invoices still received as paper, the case for combining effective AP Segmentation with efficient AP automation is compelling and clear.[1]

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However, automation should not be the first step. A key assumption that underlies this framework is that it is a rules-driven approach. Therefore, a business needs to know what rules to apply to invoices. That leads to AP Segmentation as a foundation for effective automation.

In other words, simply automating a manual process—and particularly a bad process—will not produce optimal results.

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Cutting Costs, Realizing Opportunity in AP

AP Segmentation and the planning that goes into creating a segmentation strategy deliver benefits in three key categories.

Reduced transaction costs. Prompt payment of invoices helps avoid late penalties and maintains favorable relationships (and terms) with vendors. Additionally, since much of the transaction cost in AP comes from manual processes, identifying invoices that can be fully automated versus Critical AP that may require manual intervention allows a company to maximize its staff efficiency while minimizing costs. It enables a company to deploy its finance staff to where it is most needed and where it has the greatest impact.

For example, a major hospitality business had a decentralized process for approving invoices at each of its properties, including separate checking accounts for payment. In its AP Segmentation analysis, the company identified invoice segments that could be approved centrally and those that needed approval at the property level. Implementing an automated solution based on that analysis, along with creating a centralized payment account, produced greater operational efficiency, lower transaction costs, and improved vendor relationships.

> One leading international company identified more than 2,000 invoices each month that were paid erroneously, including payments to vendors with which it no longer had relationships.

Greater transparency and control. For certain types of payments (such as tax), control of the payment process is the primary objective of this approach. AP Segmentation is the best method to identify what invoices should be targeted for priority handling.

[1] Aberdeen Group, The Invoice Reconciliation and Payment Benchmark Report, June 2006.

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It can also enable a company to identify invoices that represent potential fraud, unauthorized spending, or noncompliance with contract billing terms.

AP expert Mary Schaeffer points to an array of fraud-related problems that can occur in the absence of a well controlled AP process. Noting that financial institutions lose about $12 billion annually "in check fraud alone," she also cites such issues as phony invoice fraud, vendor fraud and employee fraud. She even cites the well publicized cases of employee expense account abuse that recently embarrassed such organizations as Wal-Mart and American University.[2]

Duplicate and erroneous payments are another vast, unaddressed problem. One leading international company identified more than 2,000 invoices each month that were paid erroneously, including payments to vendors with which it no longer had relationships. Implementing an effective AP Segmentation strategy in conjunction with AP automation eliminated erroneous payments and improved process efficiency.

AP Segmentation combined with automation can also ease the burden of compliance by providing uniform oversight. Business rules based on established segments flag invoices for review when company-defined control parameters are met or not met, as the case may be. With automation, these parameters can be set to flag any kind of exception, be it a data discrepancy or budgeting variance, to name just a few examples.

Higher process efficiency. Segmenting AP provides a proactive analysis of invoices as part of an effective process automation and spend management initiative. It also enables companies to reduce cycle times on Critical AP and avoid the problems that result from inefficient AP processing.

For example, a major nonprofit organization relied heavily on telephone fundraising. However, inefficient processes caused invoices to be paid late, and missed telecom payments led to the organization losing its phone service, severely impacting its operation. The organization used AP Segmentation to identify telecom and other Critical AP as candidates for AP automation, giving those invoices higher priority as it undertook additional changes to improve its overall AP process.

Transforming AP Through AP Segmentation: JurysDoyle

One company that demonstrates the power and potential of transforming AP by using AP Segmentation is JurysDoyle. With a portfolio of eleven hotels worldwide and four in the United States, the company has taken a new approach toward AP that enables it to focus on its most critical payables while improving processes and controls and lowering costs.

Situation faced. Competing in a highly competitive marketplace for hospitality services, JurysDoyle recognized that it must continually upgrade and enhance its financial processes. Only through such actions would the company be able to remain responsive to auditing and compliance requirements while increasingly shifting the attention of its finance group to strategically critical activities.

The hotel group realized it needed to continually enhance financial processes— and other business processes—to maintain successful supplier relationships and generate new customer value. With these objectives in mind, the organization decided to explore outsourcing and automating accounts payable.

Action taken. Working with Paypool, Inc., JurysDoyle engaged in an AP Segmentation exercise by which it identified certain properties that were having a disproportionately negative impact on overall AP performance. As a result, JurysDoyle decided to initially automate the activities of one of its high-value properties

> JurysDoyle realized net savings of $30,000 associated with the elimination of paper-based procedures and the ability to leave one position unfilled when the employee gave notice.

[2] Mary S. Schaeffer, An Accounts Payable Game Plan: What You Don't Know About AP Can Hurt Your Bottom Line, Amazon Shorts, 2005.

in the U.S., the Normandy Hotel in Washington, D.C. The initial plan was to conduct a 90-day evaluation before moving to the next underperforming property. Instead, based on the immediate results gained from prioritizing their accounts payable prior to automation, the organization quickly decided to put all four of its American hotels on the program within that timeframe.

With a rapid rollout and a compelling demonstration of business benefits, JurysDoyle gained the confidence to centralize and automate all of its domestic AP activities. Its success with AP automation would not have been possible without first engaging in AP Segmentation. As Doug Bridegum, regional controller for JurysDoyle Hotel Group USA, explains, *"Segmenting our AP prior to any automation program allowed us to identify the areas where we needed to focus our attention most. The end results were immediate and tangible for us."*

Resulting impact. Having automated the system, JurysDoyle managers now had online access to invoices and the ability to handle the AP process with far greater productivity. Indeed, team members now have the ability to approve invoices electronically and ensure that critical ones receive thorough attention and consideration. In this sense, the company is now able to prioritize its payables, eliminating the pressure to process them all in rapid succession to close the monthly books.

There were also key payoffs associated with audits and compliance. Where previously JurysDoyle had filed accounting materials in boxes on-site and off-site, it now was able to store them in an electronic format and access them rapidly. Preparing for an audit would have once taken 30 days; now invoices going back several years could be accessed by auditors via the web or presented on a DVD-ROM within a single day. *"When auditors from the I.R.S. and the Washington, D.C. government came in, I just handed the DVD to them and said, 'Here you go,'"* says Doug Bridegum. "They are used to being surrounded by boxes of old invoices and going through them one by one. Needless to say, the audits went very smoothly."

While enhanced process efficiencies and strengthened financial controls were the main benefits of the initiative, the company also realized net savings of $30,000 associated with the elimination of paper-based procedures and the ability to leave one position unfilled when the employee gave notice. *"The new approach has had an unbelievable impact on our performance,"* says Bridegum. *"It's just really, really smart for our business."*

Successful AP Segmentation

There are five critical success factors in an effective AP Segmentation strategy.

1. **Identify AP problems and opportunities.** Uncover areas where AP is having a negative impact by examining the key performance indicators (KPIs) associated with AP to identify pain points and isolate AP problems. Instead of looking at invoices as simply bills that need to be paid at some point, look at them as transactions that can increase revenue or save money.

2. **Define, refine, and document segments.** Documentation of all AP segments identified is essential so that these segments are unambiguously translated to the people, processes, and technology that support the AP function. It is also important to ensure that the rationale behind AP Segmentation is persistent despite personnel changes. This documentation should be maintained as segments are refined, updated, and created.

3. **Determine what segments classify as critical AP.** Critical AP can vary from one organization to another and may mean different things depending upon what market segment a business is in and what its pain points are. Whether payables are associated with capital allocation, tax bills, telecom services or some other criterion, companies need to get a handle on which payables deserve particular attention.

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4. **Rethink processes to support new AP segmentation strategies.** Identifying AP segments leads a company to consider how to handle these segments. Perhaps new processes for Critical AP would ensure discounts. Maybe identifying and segmenting invoices from certain vendors for delayed payment is needed for short-term cash management goals. Do staff members need to be reassigned or retrained to effect the change? Now is the time to fix bad processes by rethinking and redesigning processes and by investing resources in high-value initiatives related to Critical AP.

5. **Determine how to effectively manage the AP segmentation.** In creating a solution that translates the results of an AP Segmentation strategy into a sustainable process, companies need to judge each solution option by the traditional measures of cost, control, and efficiency.

Will hiring more people to deal with Critical AP sufficiently address the problem, or does that simply compound inefficiency and increase cost? Can existing technology be leveraged to support the new process or are new solutions needed to provide adequate control? What role can outsourcing play to reduce costs?

Outsourcing some or all of Critical AP to a provider that is appropriately certified can provide control and efficiency at a competitive cost. Outsourcing can be used to handle part or all of Critical AP, or it can be an effective way to manage any AP segment in a way that delivers improved control, visibility, and access to information.

> The 80/20 rule shows that making significant improvements—and gaining positive returns—in the AP process does not take an "all or nothing" approach.

Encouragingly for businesses facing the constraints of time, money, and resources, the 80/20 rule shows that making significant improvements—and gaining positive returns—in the AP process does not take an "all or nothing" approach. AP Segmentation enables a business to focus its efforts on its most important invoices, while spending minimal time on others, enabling it to reduce costs, improve KPIs surrounding payables, and maximize revenue opportunities. AP Segmentation thereby becomes the foundation for iterative changes in the way a company manages its invoices, leading to the ultimate goal of optimization of the AP process.

About Paypool

Built on the premise that all payments are critical, Paypool was created in 2001 to transition any AP transaction to an automated solution. We combine our proprietary technology with unmatched customer service to deliver a complete Software-as-a-Service solution. Clients retain efficient workflows while gaining greater visibility and control, better cash flow management, streamlined approval processes, 24/7 accessibility, and increased auditor confidence. Paypool works with clients ranging from non-profit associations to some of the largest multinationals. We are headquartered in Washington, DC, and are SSAE 16 SOC compliant.