
UNIT 7 PAYMENT PROCESS

Structure

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7.0 OBJECTIVES

The objectives of this unit is to familiarise the learners with:

- how payments are made to the vendors after their invoices have been cleared for payment;
- things to keep in mind and be careful about while handling payments; and
- how rejected payments are handled.

7.1 KEY TECHNICAL TERMS

Payment process is a specialised process and before we talk about it further, it may be a good idea to get familiar with some terms which are used frequently during this process.

Payment batch: A computer program in the ERP environment, which identifies all the invoices that need to be paid and creates a list of payments to be made.

Payment batch name: Unique name to identify the payment batch. Different companies use different formats for defining this name.

Payment date / Value date: Payment Date is the date by which the supplier can expect the money in his account.

Pay-through date: Pay through date is the date, until which the invoices due for payment will be picked up in the payment batch.

Payment run date: The date on which the payment process is executed.

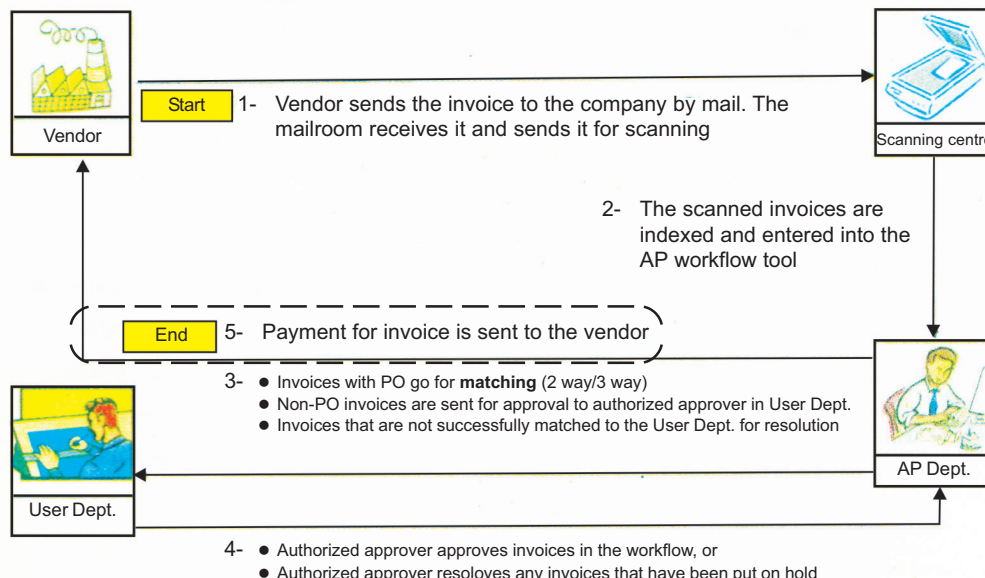


Fig. 7.1: A Process Cycle

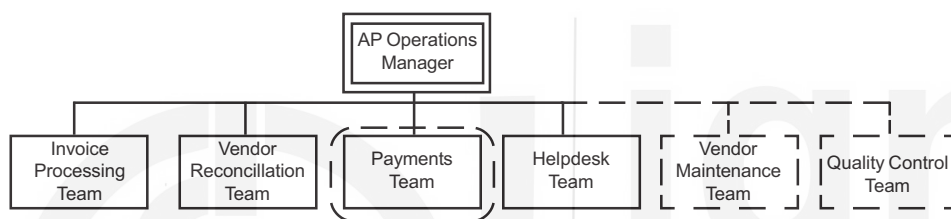


Fig. 7.2: Structure of the AP team

Payment Currency: The currency in which payments get transacted.

Payment Document: Payment Document is the document through which the payments are made. There are various types of documents for various payments created in the ERP. There is one document created for each payment.

Payment register: The payment documents created in a single payment run are combined into a payment register.

7.2 INTRODUCTION

We have so far looked at:

1. How invoices are received by client and processed for payment?
2. How issues relating to invoices are resolved?
3. What are the frequent errors that can happen while processing invoices for payments?

In this unit we will look at how the payments are actually made after the invoices are cleared, what are the various options in terms of payment instruments and what care needs to be taken while creating payment runs.

Let us take a look at the entire AP cycle again. The figure 7.1 shows the AP cycle.

It indicates that the invoice processing and payments are the responsibility of the AP team.

Figure 7.2 shows the structure of the AP team which has the invoice processing team, payments team and vendor helpdesk team. The other associated support teams are Vendor maintenance and Quality Control teams.

As shown there, the payment group is a separate group. The payment group needs to be kept separate from invoice processing or vendor setup. This is needed to keep strong financial control on payments.

The invoice processing team processes the invoices by matching the invoices with POs & GRN or getting the buyer's approval for the invoices

The payment team takes over from this point.

The payments team runs a computer program in the clients ERP environment, called as payment batch', which identifies all the invoices that need to be paid and creates a list of payments to be made.

This list is called as a payment register. Based on the payment register an instruction is sent to the bank directly, instructing them to make payments as per the advice. The bank makes the payments to the vendors according to the instruction received and confirms the payments back to the client.

Let us now take a closer look into the payment process itself.

7.3 PAYMENT RUNS

From a client viewpoint, all vendors are not the same as far as their importance to the business goes. There are always some vendors who are more critical to the business than others. For example, for a car manufacturer, the suppliers for the engine, tyres and gear box will be more critical than those of paper stationery suppliers, for their office need. Engine, gearbox & tyres are critical components in a car.

In a similar manner, vendors are divided into **normal** and **critical** vendors.

1. Critical vendors are accorded a higher priority in invoice processing as well as payment processing, since paying them on time is extremely important for the business.
2. They are usually paid earlier than normal vendors for the same reason.

The payment runs happen according to a scheduled frequency, which can be daily, weekly, twice a week, once in two weeks or monthly.

The schedule is specified by the client for each currency that the payments deal with e.g. the client may have a policy of having a payment run daily for US Dollar and twice weekly (Tuesday and Friday) for the Euro currency.

While entering an invoice, invoice processing team specify the payment currency this information is useful for the payment batch program to identify the specific payment currency for an invoice.

Payment team needs to take the forecast report for all the due invoices which will be included in the next payment run and this report needs to be sent to treasury for ensuring fund availability in the payable account.

The payment process is shown in the diagram as follows:

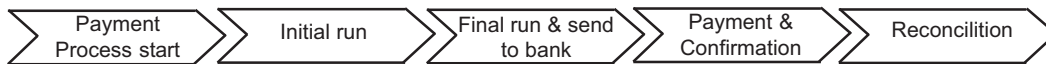


Fig. 7.3: Payment Process

When the payment process is run in the ERP, it follows the following steps:

1. The payment process in ERP gets initiated:
 - a. The payment run date is set according to the payment schedule specified by the client.
 - b. On the payment run date, a unique identifier/name (called as payment batch name) is generated for the process and a pay-through date is specified for it.

(Note: Refer to section 7.1 for explanation on the terms used during the process run)

2. The payment process undergoes an initial run. (Initial run can be compared to a practice run. The results of an initial run could contain payment errors like duplicate payments, incorrect payments etc. as well as error fixes done from the previous runs, which are checked, identified and corrected before the final run. Without the initial run, the incidence of mistakes in the payments can be very high and may result in financial losses to the client as well.)

The following steps are followed in an automated computer program which runs in the ERP.

- a. The invoices to be paid are identified. Payment date of the invoice is compared with the pay through date of the payment batch program. The invoices where the payments dates are earlier than or equal to the pay through date are picked up for payment.
- b. These invoices are collated together. In case there is more than one invoice for a particular vendor then the amounts payable on all the invoices are totaled up into a single payment document.
- c. If any vendor owes money to the client (due to goods rejected or returned, due to any advance payment made for the purchases or due to duplicate payments made in the past), the existing balance in the vendor's account is adjusted against the payment.
- d. A preliminary payment register is generated. This payment register contains the details for all the invoices that are payable by the pay through date.
- e. This preliminary payment register is reviewed by the payment team. The team checks for:
 - i. Duplicate payments (a check is done with the recent payments in case there are any duplicate payments being made)
 - ii. Any previous payment fixes (i.e. if a particular payment transaction could not go through from the previous batch run, due to some errors,

it is verified whether it is included in the current batch after the errors have been removed)

- iii. High value payments (high value payments e.g. all payments higher than \$ 50,000 are rechecked as to whether they have been processed correctly or not).
 - iv. The currency for which the payment batch is being run is checked. This is important because sometimes it could happen by mistake that an invoice payable in low value currencies like Japanese Yen, or Italian Lira gets processed for payment in a high value currency like US dollar or Euro. So the client could end up paying 5000 US Dollars instead of 5000 Yen.
3. Once all errors from the initial run have been corrected and fixed, the process undergoes a final run.
- a. The final payment register is generated and approved by the client.
 - b. The payment register, containing payment instructions is sent to the bank directly through the ERP over the computer network.
4. The bank arranges to make payments as per the instructions in the payment register.
- a. Once the payments have been executed, the bank sends a confirmation file to the client.
5. The confirmation file is reconciled with the payment register that had been sent to the bank. If there are any payment rejections then the payment document is turned void.
- a. Through the ERP, the remittance details are sent to the vendor. The remittance details provide the information about the payment and which invoices have been paid through this payment. This information is used by the vendor to apply cash (i.e. to recognise the payment against the particular invoices in his account books).
 - b. The reasons for the payment rejections are investigated and fixed (usual time for this is the next payment run or within 5 business days).

☞ We need to understand the difference between various dates, that we are discussing in this unit.

The **payment run date** is the date on which payment process is run.

The **payment date** is date on the invoice by which that invoice needs to be paid.

The **pay through date** is the date up to which all the invoices pending for payment will be picked for payment in the payment run.

For example, let us assume that there are two invoices with the payment dates of 11 -Jun-2017 and 14-Jun-2017 respectively.

- The payment run happens on 08-Jun-2017 and the pay through date is 12-Jun-2017.

- In this case, the first invoice will be picked up for payment and the second invoice will be discarded.
- It will be considered in the next payment run.
- In case the pay through date for the payment run had been 14-Jun-2017 then the second invoice would have been picked up for payment too.)

7.4 PAYMENT INSTRUMENTS

As discussed earlier, the payments register is sent to the client's bank. The bank arranges to make the payments.

Payment can be made through the following instruments:

1. **Cheque (Check):** From the instructions sent to the bank, the bank/ client/ printing solution needs to print the cheque along with the remittance advice and dispatch to the supplier.

The cheques are printed and dispatched to the vendor by mail.

Cheques as a means of payment are losing popularity among large clients due to following reasons:

- These are sent by mail which can result in delays or cheques getting misplaced. It is also costly as there are mailing costs involved.
- The vendor payments are delayed which leads to vendor dissatisfaction.
- Since the payments are confirmed only after the vendor presents the cheque to his bank, the client's bank account is not reconciled.

2. **Electronic Funds Transfer (EFT):** It is also called "Automated Clearing House" (ACH). It is a way of making payments electronically directly into the vendor's bank accounts. Once the ACH payment has been processed, remittance advice needs to be sent to the supplier through email (e-remit/ by post).

There is an intermediary involved in settling the transaction between the client's bank and the vendor's bank. This intermediary is called a "clearing house." The role of the clearing house is played by the central bank of the country for example RBI in India, Federal Reserve in the US and Bank of England in UK.

The EFT works in the following manner:

- a. As part of the payment register, the payments team passes on the details of the vendor's bank account (account number and routing code) to the client's bank (these details are available in Vendor Master) within the ERP.
- b. Along with the amount that needs to be paid into the vendor's account. The client's bank sends the instructions and money to the clearing house to make that payment into the vendor's account.
- c. The clearing house transfers the money to the vendor's bank directly

along with the instructions on which account the money should be transferred to.

- d. The vendor’s bank transfers the money to the vendor’s bank account.
- e. The client’s bank is informed whether the transfer instruction has been completed or not (the reasons why some payment instructions are not completed are discussed in section 7.5).
- f. The client’s bank sends a confirmation file on the payments so that the client can reconcile the payments instruction against the actual transactions executed.

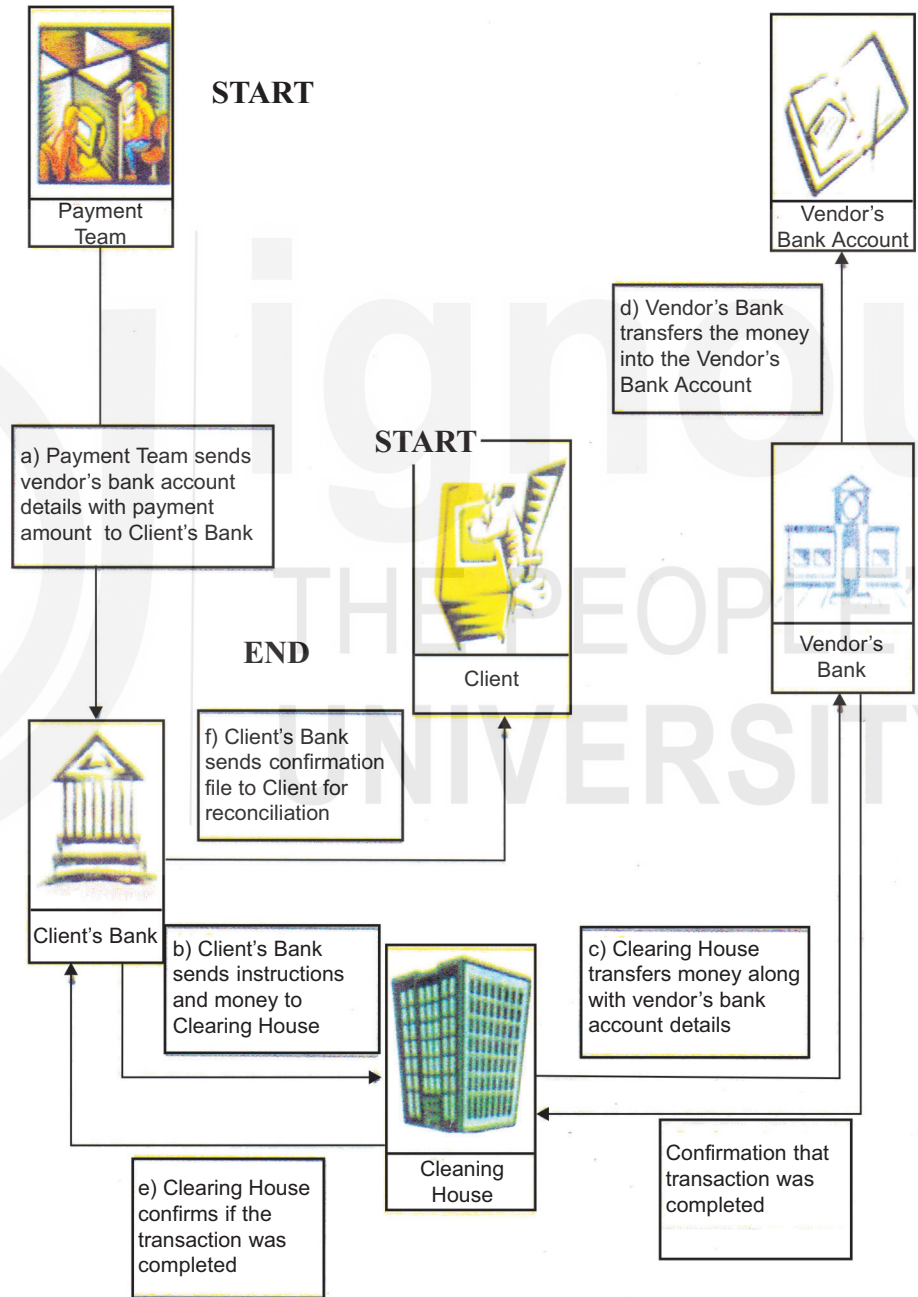


Fig. 7.4: EFT Process Cycle

For example, the client has his account with State Bank of India (SBI), Nariman Point Branch, Mumbai and the vendor has his bank account with HDFC Bank, MG Road, Bengaluru.

- The role of the clearing house is played by the Reserve Bank of India (RBI).

- The client needs to pay the vendor Rs. 24,000.
- The client sends the payment instruction to its banker, SBI.
- SBI sends a payment of Rs. 24,000 to the clearing house (RBI) and also sends instructions to transfer Rs. 24,000 to the vendor's account by providing the vendor's account number and the routing code of HDFC Bank, MG Road, Bengaluru.
- The clearing house (RBI) transfers the money and confirms back the transaction. Based on this confirmation SBI sends a report to the client.

It usually takes two business days for the money to appear in vendor's account when EFT is used.

3. **Wire transfer:** The wire transfer is also an electronic payment method but it happens directly between two banks. A clearing house is not involved.
 - a. The payments team passes on the details of the vendor's bank account (account number and routing code) to the client's bank along (these details are available in Vendor Master within the ERP) with the amount that needs to be paid into the vendor's account.
 - b. The client's bank transfers the funds directly to the vendor's bank account.
This method of payment is costly (usually a transaction fee of \$15 is charged by the bank for every payment transaction). It is the preferred way of making international payments when the vendor's bank account is in a different country other than the client's bank.

Quality Performance Measurement

When the payments process is outsourced then the client measures the quality of the process and the performance of the payments team which is working on this process. The performance measurement criteria/parameters used for this are called process metrics. The metrics used to measure the quality of payments process are:

1. **Accuracy:** refers to the correctness of the data that are entered to process the payments. The accuracy metrics that is measured for payment runs are:
 - a. Percentage of invoices that were paid on time.
 - b. Percentage of payment proposals that were executed with correct dates.
 - c. No. of payment rejects per day
 - d. Percentage of duplicate payments
2. **Turnaround Time (TAT):** This is the average time taken to complete a payment run. The TAT metrics that are measured for payment run are:
 - a. Number of invoices unpaid past due date
 - b. Average time taken from the receipt of invoice to making the payment
3. **Productivity:** This refers to how many payment requests have been completed within a given amount of time. The productivity metrics that are measured in payment processing are:
 - a. Total daily disbursements (by value)
 - b. Total daily disbursements (by transactions)

7.5 PAYMENT REJECTIONS AND RECONCILIATIONS

Not all payments instructions that are sent to the bank are completed. The reasons could be as follows:

1. The bank account details provided for the vendor are invalid.
2. The clearing id or the routing code for the bank is invalid.
3. The payment document is invalid e.g. the instructions for a wire transfer have been provided on an EFT document or vice versa.
4. The vendor's account has been closed.

The payment confirmation file is sent back by the client's bank on the completed payments. This is used to reconcile with the payment register that was originally sent to the bank. In case there are any payment rejects, the payment document is turned 'Void' in ERP and the reasons for payment rejections are fixed. The invoice is taken up for payment in subsequent payment runs.

7.6 FREQUENT ERRORS DURING PAYMENT RUNS

The following errors may occur during payment runs:

1. **Duplicate payments:** The payments might be made more than once on the same invoice.
2. **Incorrect setting of pay through dates during the payment runs:** If the pay through date is not set properly then it can result in payments not being made in time. For example, if the payment run happens on 16-Feb-2018 and all invoices pending for payment up to 22-Feb-2018 need to be paid during this run then the pay through date should be set at 22-Feb-2018. If by mistake, the pay through date is set to 21-Feb, then all the invoices which need to be paid on 22-Feb-2018 will not be paid on time as they will be taken up only in the next payment run. This will adversely impact the service level agreements committed to the client by the outsourcing team on-time payments.
3. **Incorrect invoice amount entered for payment:** The invoice processing team may enter incorrect amount for the invoice to be paid. For example, one extra zero (0) added to the amount by mistake may result in a huge payment to the vendor. Let us say the vendor needs to be paid \$ 400 but due to such an error the client may end up paying him \$ 4000. Although, in this case the origin of error lies in the invoice processing stage, the payment team can catch this error by auditing the payment process properly.
4. **Payments in the incorrect currency:** The payment currency may be incorrectly set in the payment run due to which the amount specified to be paid on an invoice may get paid in a different currency. This is particularly damaging to the client when invoices are denominated in low value currencies and get paid using high value currencies. For example Italian Lira and Japanese Yen are low value currencies. If an invoice for 5000 Italian Lira is paid for by mistake in 5000 Euros then the client suffers a loss. Payment team needs to

validate foreign currency payments and check the conversation rate before proceeding with payments. It will help to reclaim VAT with correct value and help treasury to buy the foreign currency.

5. **Exceptional Report:** Payment team needs to take the report once the payment run is completed as this report contains all the invoices with the due date which fall within the payment run however not picked in the payment batch.

7.7 DIRECT DEBITS

Some vendors, who are extremely critical to the client’s business, enjoy such special privileges that they can get their payments by furnishing the invoices (and proof of delivery) directly to the client’s bank. The client enters into a Direct Debit Transfer contract with the vendor. In such a case invoices are paid directly by the bank without undergoing the regular invoice processing and approval stages first.

In this case, the client’s bank is instructed to make an immediate payment and is provided with a list of such vendors (to whom direct debit transfers can be made). The bank makes the immediate payment. The process to settle the transaction is as follows:

1. After the bank has made a direct payment it sends the payment transaction details to the client’s GL team.

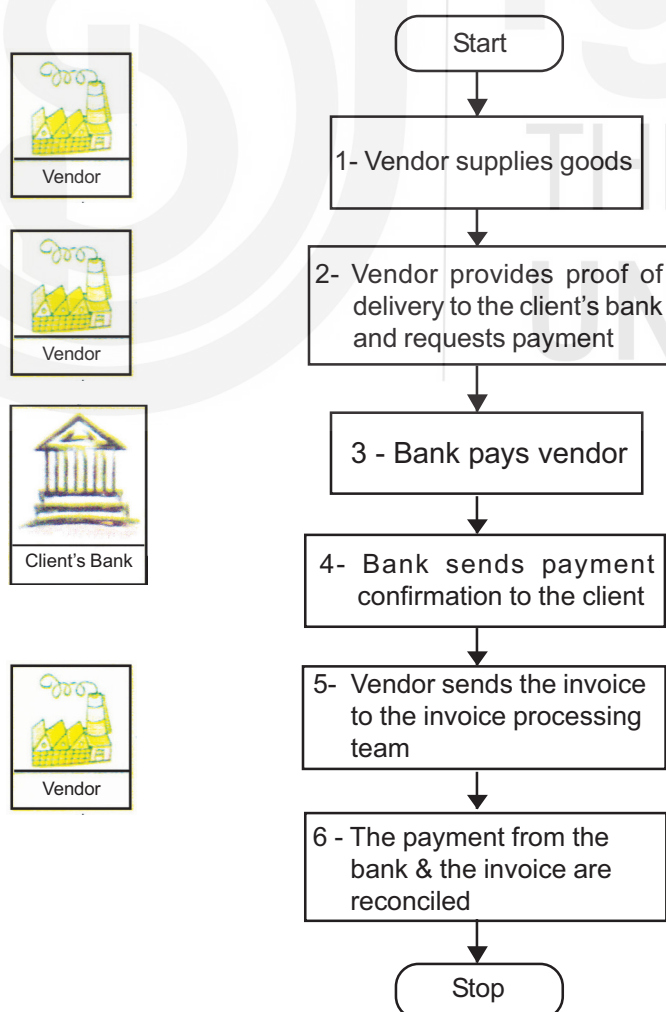


Fig 7.5: Direct Debit Payment Process

Procure to Pay

2. While doing bank reconciliation the GL Team identifies this payment transaction as an open entry, which needs to be reconciled. These open entries are passed on to the AP team for reconciliation.
3. Vendor also sends a copy of the invoice to the client's invoice processing team.
4. The invoice processing team also has a list of vendors who have direct debit privileges. The invoice is recognised as a direct debit invoice and is put on payment hold till they get the approvals to pay from the buyer and the payment details from the bank
5. Once the approval from the buyer and the payment details from the bank are received, the AP team matches the invoice received with the payment transaction and recognises the payment against the invoice.

The main issue with the direct debits is that they are very cumbersome to reconcile and settle. Usually the clients are very selective about which vendors can be paid through direct debits.

Also, to avoid the mistake of processing the invoice from a direct debit vendor for payment (like the usual process) and making duplicate payments to the vendor as a result, a payment stop can be set in the ERP against the direct debit vendors.

This will make sure that even if a direct debit invoice is processed for payment by an error, the actual payment (either through wire transfer, EFT or cheque) does not happen. The direct debit invoice should only be reconciled with the bank payment transactions that have been completed already but have not been reconciled.

Check Your Progress

1. Fill in the blanks:

- a. The unique identifier for a payment run is called as _____
- b. The date associated with a payment run up to which all invoices are paid is called as _____
- c. In EFT the intermediary involved in settling the payment transactions between two banks is called as the _____
- d. If the vendor has closed his bank account, the payment into the account is _____.
- e. When the vendor is directly paid by the client's bank and the invoice is approved later it is called _____.

2. State whether the following statements are True or False.

- a. The wire transfer is the fastest as it involves the payment instruction going from one bank to the other electronically and directly, without any intermediaries.
 - b. Cheque is most preferred way of payment in cases of an international transaction.
 - c. Business provide importance to their critical vendors
 - d. Vendors bank details are available in Vendor Master
-

7.8 LET US SUM UP

After the invoices have been processed and cleared for payment, a separate team (called as the ‘payments team’) works to make the payments to the vendors.

The payments team runs a computer program (called the payment batch) in the client’s ERP takes up all the invoices that have been cleared for payment up to a certain date (pay through date). The payment run creates a set of payment instructions (called as the ‘payments register’) which is sent to the client’s bank for it to execute these instructions.

The client’s bank executes these instructions and sends back a Confirmation File to the client which is reconciled with the original transactions in the payment register.

Some very critical vendors also have an arrangement to get payments quickly and on a priority directly by furnishing the payment request to the client’s bank. This kind of payment transaction is called as the ‘direct debit’. The vendor gets the payment first and the AP team approves the invoice and reconciles the payment against it later.

7.9 KEY WORDS

Automated Clearing House (ACH): It is a means to make payments electronically by one bank transferring the money to another using an intermediary called “clearing house”.

Cheque: It is a payment instrument where the payment instructions are provided by the client to the bank on a paper form. The paper form is also called a cheque. The payment instructions are written on the form and it is handed over to the payee. The payee can present the cheque to his bank and receive the payment.

Clearing house: It is an intermediary which settles the fund transfer requests between various banks.

Critical vendor: The vendors whose relationship is critical to the clients business. The client makes sure that the critical vendors are kept satisfied by making timely payments.

Direct debits: The process of buyer’s bank directly paying the vendor, before the invoice gets approved by the buyer, and the transaction getting settled later in the buyer’s books.

Electronic funds transfer (EFT): See ACH.

Metrics: Measurements taken on an activity to measure its quality.

Payment batch name: Unique name to identify the payment batch. Different companies use different formats for defining this name.

Payment Currency: The currency in which payments get transacted

Payment date: Payment Date is the date by which the supplier can expect the money in his account.

Payment Document: Payment Document is the document through which the payments are made. There are various types of documents for various payments created in the ERP.

Payment register: The payment documents created in a single payment run are combined into a payment register.

Payments rejections: The payment transactions that the bank can not execute due to target account number being invalid, closed or other payment details being invalid.

Payments run date: The date on which the payment process is executed.

Pay-through date: Pay through date is the date till which the invoices due for payment will be picked up in the payment batch.

Payments team: It is the team within the Accounts Payable team that makes the payments on the invoices that have been cleared for payment.

Routing code: It is the number which carries the particulars of a bank and its branch. The payment being made electronically into a bank account needs to specify the routing code of the bank and the account number.

Value date: (see payment date)

Wire transfer: The method of payment where the payer's bank directly transfers the money to the payee's bank (without going through an intermediary). Compared to ACH this process of making payments is fast however costly.

7.10 ANSWERS TO CHECK YOUR PROGRESS

1.
 - a. Payment batch number
 - b. Pay through date
 - c. Clearing house
 - d. Rejected
 - e. Direct debits
2.
 - i. True
 - ii. False
 - iii. True
 - iv. True

7.11 TERMINAL QUESTIONS

1. Differentiate between the following:
 - a. Critical vendors and Normal vendors
 - b. Payment run date, payment date and pay through date
 - c. EFT and wire transfer
2. Explain step by step, what happens after the payment register is sent to the bank to execute the payment instructions.
3. List some of the frequent errors that happen during the payment runs.
4. Why is it important to keep the payments team separate from the invoice processing and vendor set up teams?
5. Explain the direct debit form of payment.