White Paper

A Strategic and Practical Approach to Optimizing Financial Reporting in an Increasingly Dynamic World

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Executive Summary

Over the past decade, companies have invested significant effort into making the close cycle faster. More recently, leading companies have begun to shift their focus towards making the close process more efficient and accurate. The ongoing challenge for business is how to improve processes that are inherently dynamic.

In this paper we will discuss the ways and means by which the close process can be optimized for more efficiency and accuracy using proven methodologies. Topics covered include:

(1) An overview of events in the last two decades that have triggered the trend toward an optimized financial close.

(2) Important benefits of an optimized close, especially its significance to your bottom line.

(3) Typical obstacles to achieving an optimized financial close.

(4) Steps a business can take to prime itself for achieving the optimized close.

(5) Key elements to achieving an optimized close.

Our blueprint for transforming the financial close into an optimized process—using the Lean Six Sigma methodology of continuous improvement, best practices, focused resources, and the right technology—can provide your organization with immediate positive impacts by way of improved accuracy and regulatory compliance, better investor perception and internal controls, noticeable cost reductions, and higher employee morale.

The Financial Close in the Last Decade: An Overview

The accounting close and financial reporting have held a unique dynamic within the business world. While recognized as crucial processes, they have not received the same level of scrutiny, technological focus, or process improvement initiatives as other business activities, such as sales and customer service with CRM systems or manufacturing and inventory management with systems to support ISO.

In the 1990s, newly available computing power enabled the widespread deployment of ERP (Enterprise Resource Planning) systems in businesses of all sizes. The new technology allowed accounting departments to become significantly more efficient in almost all areas of transactional accounting, data accumulation, and analysis. Unprecedented automation helped standardize most processes and supported increased growth and complexity, even as accounting staff was reduced.

The financial close was the sole exception to the automation trend and to this day remains a largely manual process managed with a simple spreadsheet.

Regulators and the financial community, convinced that delivering financial information to markets faster protects investors and improves the efficiency of capital markets, have been pressuring companies to report results in an accelerated timeframe. The financial scandals at the beginning of the 21st century brought an unprecedented level of stringency to regulatory oversight, putting greater pressure on the processes that comprise the financial close. The Sarbanes-Oxley Act (SOX) of 2002, for example, extends scrutiny beyond reporting controls to quality of information, with special emphasis on accuracy and accountability. Companies are forced to spend vast amounts of time and money on documenting and testing their financial reporting processes and controls, which only increases the complexity of the financial close and affects its overall efficiency.

Rapid globalization and the two global economic recessions of the past decade also compelled businesses to work on increasing efficiencies. Not surprisingly, general administrative expenses were the first to feel the economic squeeze. Faced simultaneously with diminished resources and increased reporting requirements, most finance departments responded by increasing the burden of manual tasks on their human resources.

Today, businesses of any significant size or complexity are compelled to:

- Complete the financial close within a market-acceptable timeframe
- Comply with constantly evolving, strict regulations and standards
- Provide a clearly verifiable trail of supporting documentation while operating under stringent budgets and with austere resources.

Faced with this reality, companies have to take a strategic view of the financial close process. Merely increasing human and technical resources, however, is an insufficient response and only adds to the cost and complexity without meeting the mandates of current economic conditions and regulatory requirements.

Current research shows that leading companies known for their best practices strongly favor solutions that can help them *optimize* the financial close, making it more efficient and effective without adding to its cost. These companies are more likely to employ a strategy that—consistent with the solutions applied to other business processes—identifies a solid improvement methodology to be implemented in conjunction with appropriate technology, best practices, and dedicated resources to optimize the close process.

Top Priorities for Improvement in the Financial Close Process

- Continuously improve the close process
- Develop and monitor close performance metrics
- Establish clear accountability for closing tasks within a closing schedule
- Enforce deadlines

Source: *Improving the Financial Close 2010*, Institute of Management and Administration, 2009, ISBN: 978-1-58673-376-6.

Why Optimization is Essential and Desirable

The Sarbanes-Oxley Act (SOX) of 2002 extends scrutiny beyond reporting controls to quality of information, with special emphasis on accuracy and accountability.

The benefits of a truly optimized financial close process, as enumerated below, extend beyond meeting regulatory guidelines and being able to report financial results early. They include:

(i) Greater accuracy of reported numbers because of timely reviews, consistent communication, and active management of items and issues.

(ii) Significant cost savings through emphasis on streamlined, manageable, and repeatable processes.

(iii) Increased investor confidence created by consistently meeting or exceeding industry and regulatory reporting expectations, which creates an environment of reporting excellence that is well perceived.

(iv) Earlier access to critical information, such as monthly financial reports needed for building and prioritizing business strategies or reacting to changes.

(v) More opportunities for accounting resources to perform value-added analyses and introduce improvements throughout the business because of a shorter close period.

(vi) Improved compliance through system-generated tracking of approvals, documents, policies, and exceptions, leading to reduced compliance overhead and verification costs.

(vii) Access to monthly financial reports that are based on an increased use and deeper understanding of historical and projected financial information more relevant to the company's operations.

Obstacles to Achieving an Optimized Financial Close

If an optimized close is so advantageous, why are companies not implementing changes right away? There are two overriding reasons: (1) a lack of time (real or perceived); and (2) an ingrained belief that the close is as good as it is going to get, given its nature.

Further analysis reveals the many legitimate concerns underlying the reasons why businesses are reluctant to tamper with the close as it exists. They are as follows:

(i) The close is a moving target. The nature of the close itself is one of constant change and evolution. As a company grows and undergoes events, such as restructuring, reorganizing, and acquisitions, the requirements of the close change. Typical process improvement efforts tend to focus on one-time reengineering projects, establishing best practices, locking down procedures, and applying automation to enforce the new procedures, which make them ineffective for a dynamic process like the close.

(ii) The close process lacks clarity and metrics. The typical close process is opaque and few companies collect metrics on the performance of the close process. This lack of visibility makes it difficult to know what changes have had the desired effect on the close.

(iii) No bandwidth to plan process improvements. Most accounting departments are caught in a cycle of continuous activity that goes from the ending of one close, to catching up on the backlog that piled up during the close, to beginning the next close period. In this environment, the accounting team simply does not have the bandwidth to analyze even current processes for possible efficiency gains, let alone implementing new ones.

(iv) The close is far too complex. Accounting environments at many large companies operate with multiple systems deployed across multiple time zones, currencies, regulatory compliance requirements, and corporate cultures. The idea of tinkering with such a multi-faceted process while working to an unforgiving deadline can be intimidating. Not surprisingly, automation is seen as the best (and only) way to make efficiency gains.

(v) Financial reporting happens on time. Most companies achieve their financial close within an acceptable timeframe and fulfill reporting requirements in accordance with regulations. The tendency is to "get it done" by "dropping new requirements into old methodologies" rather than trying to overhaul a system in the midst of a time-sensitive and critical activity. Since efficiency and effectiveness are not easily measured, the true cost of the close in human and monetary resources is not easily gauged.

(vi) The nature of the close is unchangeable. Accounting and finance departments have traditionally functioned in a very event-based manner around the close with each group maintaining its own spreadsheet of priorities and checklists, everyone focused on their own individual tasks, and communications routinely channeled through one or two people. So the concept of open communication, 360 degree visibility, and workload balancing on the fly in this environment is unimaginable.

All of these reasons, taken individually or collectively, go a long way towards explaining why companies maintain their status quo on the close.

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Evolving to an Optimized Financial Close

Companies that can redirect resources currently devoted to the close toward more value-generating activities can gain a significant competitive advantage. With a more efficient close, finance departments can move away from their traditional "score keeper" role into a forward-looking, strategic, business intelligence function. The best way to give finance departments the bandwidth to take on this new function is by optimizing the close, making that process significantly more efficient.

We have identified below the preliminary steps that a company should take to prime itself for achieving the optimized financial close:

(1) Bring senior management on board with the plan. Implementing a comprehensive solution that involves continuous improvement and adaptability requires some major overhauling, which is unlikely to happen without the firm commitment of senior management.

(2) Create a strategic plan with active project management. One of the imperatives of optimization is an overall plan with stated long-term goals for managerial financial reporting with achievable benchmarks for measuring progress on a regular basis. Having dedicated project management resources ensures smooth implementation and lowers the risk of failure due to incompletion or neglect.

Any lasting optimization efforts have to include a continuous improvement component.

(3) Evaluate existing technology. Conduct a comprehensive analysis of all currently available options—from spreadsheets to information management platforms—for managing the accounting close and financial reporting process, then carefully choose your solution based on the vendor, the underlying technology, and your future needs.

(4) Maximize your investment in technology. Gaining the most out of a technological investment requires dedicated resources to install, configure, and implement the software as an integrated part of a comprehensive effort, especially considering the critical and time-sensitive nature of the close.

(5) Identify and adapt best practices. Best practices, by definition, are those that help a company meet or exceed its current reporting obligations and are also adaptable to the needs of the future. A comprehensive analysis of current practices can help identify, develop, and modify those that can be adopted as best practices.

(6) Prioritize change management. Managing expectations and responses to change is crucial to successfully deploying the benefits of any change efforts. In the close, as elsewhere, optimized results only occur when people embrace the changes that can improve current conditions.

(7) Adopt a culture of continuous improvement. Given the nature of the financial close process, any lasting optimization efforts have to include a continuous improvement component. The Lean Six Sigma process improvement methodology is a proven one that can provide a solid foundation and common framework for everybody to understand.

(8) Deploy focused resources for a short period. Most accounting and finance departments being overworked and understaffed are likely to resist change simply because of the high-pressure, time-critical nature of the close process. To succeed at optimization, a company must be willing to deploy sufficient additional resources with relevant experience and training—for the duration of the learning period—to implement the changes with a minimum risk of failure.

Key Elements to Achieving an Optimized Financial Close

The optimized financial close is ultimately achieved through a comprehensive approach that encompasses: (i) a continuous improvement methodology; (ii) best practices adjusted to suit your company; (iii) applied technology; and (iv) a set of focused resources and strategies to start and sustain the change effort.

<u>Continuous Improvement Methodology:</u> Successful process improvement efforts are built on the foundation of a proven methodology, which can provide direction, save time, reduce risk, and increase productivity. While no single methodology chosen for process improvement can guarantee success, there are several proven methodologies that can give your project a good head start. By leveraging knowledge accumulated over several decades and the experience of others, you can create a sound strategy for your optimization project.

Some of the more widely used process improvement methodologies include *Theory of Constraints, Six Sigma, The Trilliam Model, Twelve Leverage Points, and Lean Thinking*. All of these methodologies are data driven and make heavy use of statistical analysis.

Our own choice for a close optimization process improvement methodology is *Lean Six Sigma*, which combines elements of *Six Sigma* (pioneered by Motorola for manufacturing) and *Lean Thinking*, with a focus on reducing waste to improve business processes.

<u>Best Practices:</u> Over the last 20 years accounting departments have developed a set of best practices for accelerating the close. Some of these practices focus on the timing of activities, such as moving reconciliations out of the "crunch time" and eliminating or postponing non-critical reports; others on accounting practices, such as unifying charts of accounts and using recurring journal entries. Some other practices focus on process improvement, such as assigning responsibility and deadlines for each close task, improving communications, and developing close performance metrics. To make the application of best practices both meaningful and successful, they have to be customized for a specific environment and their outcome closely monitored using established metrics to determine if they produced the desired result. <u>It takes the combination of a process improvement methodology like *Lean Six Sigma* and the application of best practices to drive the success of the close optimization effort.</u>

Applied Technology: In order to support a data-driven process optimization methodology like *Lean Six Sigma*, companies need an information system that can increase visibility, support data collection, and improve manageability of every step in the process. The system needs to be capable of functioning around the existing accounting environment and support changes to the processes and systems. The technology should facilitate the entire workflow, including the tracking of approvals and management of all required supporting documents. The best solutions will support process improvement by providing real-time and historical metrics for every step in the close process, as well as visibility to all parties involved—from preparers, to managers, to executives.

Focused Resources and Strategies: Any efforts at change are bound to encounter resistance and roadblocks, chiefly because people involved in the close are often too busy and too accustomed to the existing process to be objective about the need to change. To reduce the risk posed by resistance, a process re-engineering effort should be spearheaded by a team dedicated to bringing about the change, operating with the full cooperation of senior management. Additionally, since a continuous improvement process requires specialized training, the project leadership team should also provide necessary training to staff to make continuous process improvement an ingrained part of the culture.

What is Lean Six Sigma?

It is a process improvement methodology that combines elements of Six Sigma and Lean Thinking to help companies establish disciplined working environments focused on customer needs, detailed data analysis, and facts, not theories. The results of Lean Six Sigma process improvement projects—with its emphasis on reducing waste, making many small changes, and measuring the outcome of each change—have been nothing short of remarkable.

The key elements of the Lean Six Sigma methodology can be summed up in the acronym DMAIC illustrated below:

Define the problem.

Measure key aspects of the current process and collect relevant data.

Analyze the data to investigate and verify cause-and-effect relationships.

Improve or optimize the current process based upon data analysis,

Implement **C**ontrol systems and continuously monitor the process.

Summary

The financial close is a crucial process that has been overlooked and also proved resistant to process improvement efforts. The unique and constantly changing nature of the close requires a "total solution" approach to process improvement that has to be ongoing.

To achieve a truly optimized close, companies need a combination of:

- Sound methodology (such as Lean Six Sigma)
- Best practices
- Effective technology
- Focused strategy and resources.

Companies that invest in a continuous improvement effort for their close can reap significant benefits and achieve strategic competitive advantages.

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