



HOW TO REDUCE FRICTION AND MANAGE RISK IN YOUR FINANCIAL CLOSING PROCESS

CHRIS DOXEY, CAPP, CCSA, CICA, CPC
PRESIDENT, DOXEY, INC.

AGENDA

HOW TO MANAGE FRICTION AND REDUCE RISK IN YOUR FINANCIAL CLOSING PROCESS

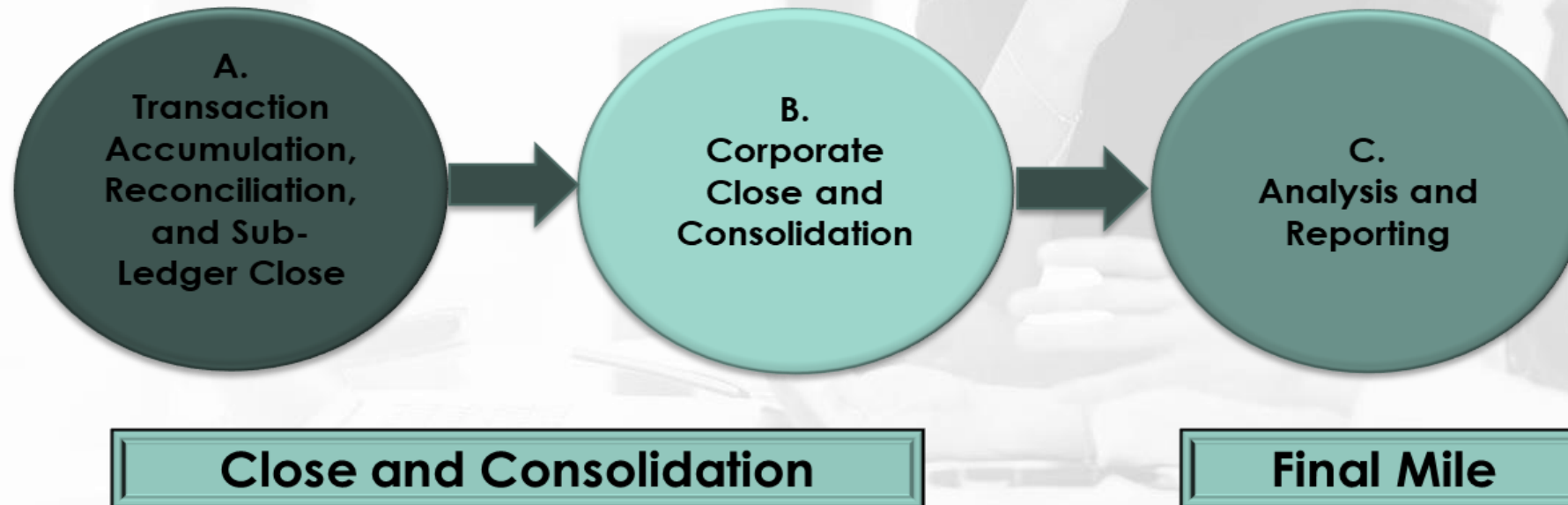
- An Overview of the Financial Closing Process
- Using Red Flags to Mitigate Risk
 1. Underlying Operational Fraud
 2. Friction and Weaknesses in the Closing process
 3. Economic Distress and Financial Reporting Fraud
- Your Scorecard for the Financial Close
- 10 Best Practices to Improve Your Financial Close
- Q&A



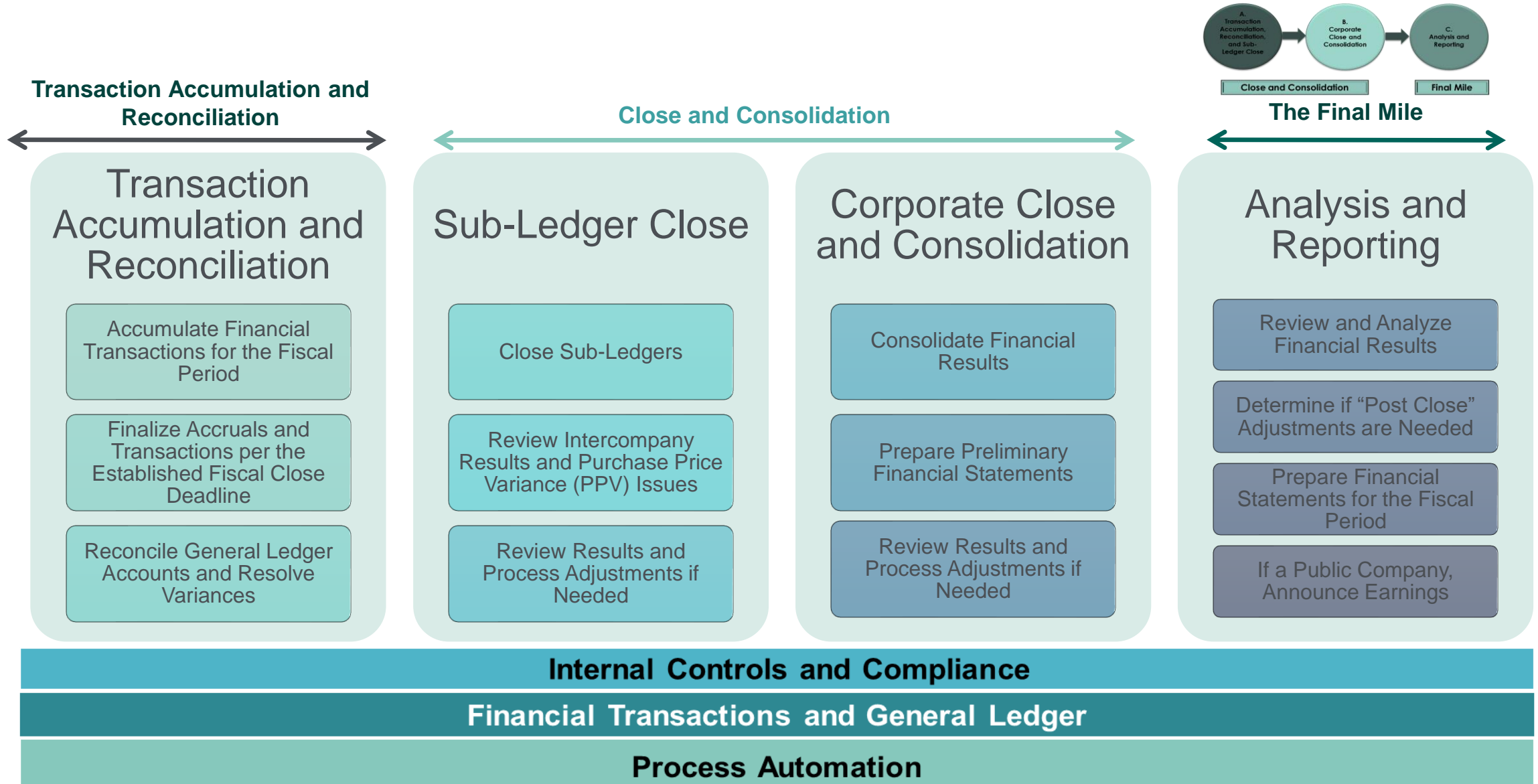
AN OVERVIEW OF THE FINANCIAL CLOSING PROCESS

KEY COMPONENTS OF THE FINANCIAL CLOSING PROCESS

- A. The **Financial Closing Process** starts with **Transaction Accumulation, Reconciliation, and Sub-ledger Close**.
- B. The **Corporate Close and Consolidation** process includes the close of business units and the completion of the adjusted trial balance, and the first pass of consolidated financial statements.
- C. The “Final Mile” is the **Analysis and Reporting Cycle**.



AN OVERVIEW OF THE FINANCIAL CLOSING PROCESS








USING RED FLAGS TO MITIGATE RISK

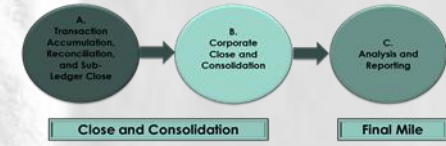
POLLING QUESTION 1

- 1. How long does it take to complete your financial closing process?**
 - a. Less than 4 business days
 - b. 4-7 business days
 - c. 7-10 business days
 - d. Over 10 days
 - e. We don't measure our cycle time

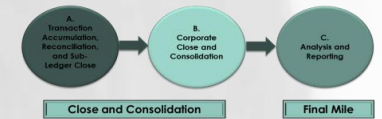
AREAS OF RED FLAGS

WHERE ARE THE PROBLEMS?

1. Underlying operational fraud 
2. Friction and weaknesses in the closing process 
3. Economic distress and financial reporting fraud 



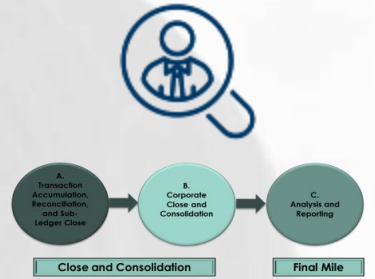
1. UNDERLYING OPERATIONAL FRAUD



- Too many surprises
- Lack of timely reporting
- Period-end cut-off errors
- Lack of supporting documentation
- Lack of consistent processes
- Excessive post close adjustments
- Significant and/or material control weaknesses

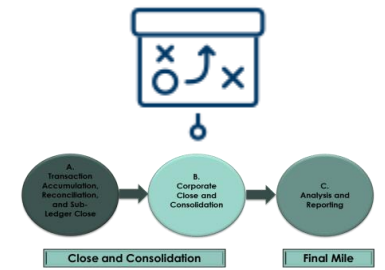
1. UNDERLYING OPERATIONAL FRAUD

(Continued)



1. The closing process is completed 1-2 weeks after the period end.
2. No formal management review of the financials is completed after every closing cycle.
3. The driving force behind completing the financial reports is an external reason; bank covenant reporting, tax payments, government reporting, etc.; rather than a sincere belief that the results are a key management tool and report the financial health of a company.
4. The company's financial statements are not integral to the company's forecasting system.
5. The accounting and finance team is focused on past shortcomings and is not focused on improving or automating the financial close.
6. Executives are not “pushing” to complete the financial reporting process as soon as possible each month.

2. FRICTION AND WEAKNESSES DURING THE CLOSING PROCESS



1) MISSING THE BASICS

- A lack of focus on the process “basics” such as closing process checklists, reporting templates, standard operating procedures, and business continuity plans.

2) FIREDRILLS

- The closing process exceeds the expected benchmark,
- The finance department resembles a fire-drill during the financial close process.
- All other finance activity shuts down during the closing process.

3) LACK OF STAFFING AND TRAINING

- An absence of staffing and training plans creating a resource gap during each closing cycle.

4) LATE REPORTS AND DISCONNECTS BETWEEN INTERNAL AND EXTERNAL REPORTING

- Reports are too late, too difficult to understand, overly complex, suspect or often revised.
- There are variances between internal and external financial reports and conflicting reports.

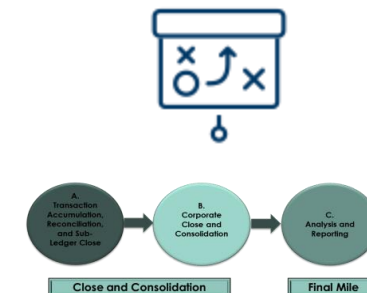
5) CHART OF ACCOUNTS CHALLENGES

- There are multiple, nonstandard or overly complex charts of accounts (the basic ‘bones’ of the accounting system).

6) NO METRICS OR KPIs

- There is a limited capacity or ability to report operational metrics or KPIs.
- A lack of “checks and balances” can result in undetected financial statement fraud.

2. FRICTION AND WEAKNESSES DURING THE CLOSING PROCESS (Continued)



7) MULTIPLE GENERAL LEDGERS AND DISPARATE SYSTEMS.

- Multiple general ledgers and disparate transactional systems with inconsistent data structures that must be mapped to a consistent reporting format.
- There are disparate and disconnected business and financial systems.

8) LACK OF VISIBILITY

- A lack of visibility to the status and execution of the closing process, and the related tasks and evidence gathering performed by finance, with the knowledge of these processes in the heads of just a few employees.

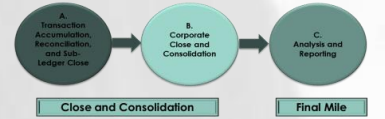
9) SPREADSHEETS

- Limited reporting capabilities that have propagated spreadsheet-based reports that house critical financial results which are the company's "corporate records".
- Spreadsheets are used to support multiple manipulations of the same data over and over to meet various reporting requirements.
- Critical reports are often created in spreadsheets.
- There are no standards or controls for spreadsheets.

10) LACK OF AUTOMATION

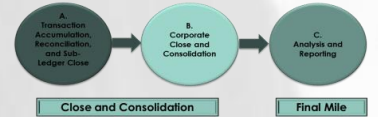
- Manual processes are error-prone and there can be a duplication of efforts.

3. ECONOMIC DISTRESS AND FINANCIAL REPORTING FRAUD



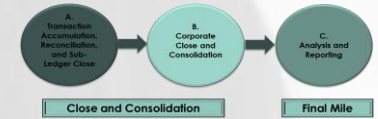
- 1. Rising Debt-to-Equity Ratio:** This indicates that the company is absorbing more debt than it can handle. A red flag should be raised if the debt-to-equity ratio is over 100%. You can also take a look at the falling interest coverage ratio, which is calculated by dividing net interest payments by operating earnings. If the ratio is less than five, there is cause for concern.
- 2. Several Years of Revenue Trending Down:** If a company has three or more years of declining revenues, it is probably not a good investment. While cost-cutting measures—such as wasteful spending and reduction in headcount—can help to offset a revenue downturn, it probably won't if the company has not rebounded in three years.
- 3. Large “Other” Expenses on the Balance Sheet:** Many organizations have “other expenses” that are inconsistent or too small to really quantify, which is normal across income statements and balance sheets. If these “other” line items have high values, then you should find out what they are specifically, if you can. You'll also want to know if these expenses are likely to recur.

3. ECONOMIC DISTRESS AND FINANCIAL REPORTING FRAUD (Continued)



4. **Unsteady Cash Flow:** Cash flow is a good sign of a healthy organization but it should be a flow, back and forth, up and down. A stockpile of cash can indicate that accounts are being settled, but there isn't much new work coming in. Conversely, a shortage of cash could be indicative of under-billing for work by the company.
5. **Rising Accounts Receivable or Inventory in relation to sales:** Money that is tied up in accounts receivable or has already been used to produce inventory is money that cannot generate a return. While it's important to have enough inventory to fulfill orders, a company doesn't want to have a significant portion of its revenue sitting unsold in a warehouse.
6. **Rising outstanding share count:** The more shares that are available for purchase in the stock market, the more diluted shareholders' stake in the company becomes. If a company's share count is rising by two or three percent per year, this indicates they are selling more shares and diluting the organization's value.

3. ECONOMIC DISTRESS AND FINANCIAL REPORTING FRAUD (Continued)



7. **Consistently Higher Liabilities than Assets:** Some organizations experience a steady stream of assets and liabilities as their business does not hinge on seasonal shifts or is less affected by market pressure.
8. **Decreasing Gross Profit Margin:** As this measures a company's ratio of profits earned to costs over a set period of time, a declining profit margin is cause for alarm.

THE BENEISH M-SCORE

IDENTIFYING EARNINGS MANIPULATION

About the M-Score

- Created by Professor Messod Beneish, the M-Score is a mathematical model that uses eight financial ratios to identify whether a company has manipulated its earnings.
- The variables are constructed from the company's financial statements and create a score to describe the degree to which the earnings have been manipulated.

THE BENEISH M-SCORE (Continued)

CALCULATION OF THE M-SCORE

1. **Days' Sales in Receivables Index (DSRI):** This measures the ratio of days' sales in receivables versus prior year as an indicator of revenue inflation.
2. **Gross Margin Index (GMI):** This is measured as the ratio of gross margin versus prior year. A firm with poorer prospects is more likely to manipulate earnings.
3. **Asset Quality Index (AQI):** Asset quality is measured as the ratio of non-current assets other than plant, property and equipment to total assets. AQI is the ratio of asset quality versus prior year.
4. **Sales Growth Index (SGI):** This measures the ratio of sales versus prior year. While sales growth is not itself a measure of manipulation growth companies are likely to find themselves under pressure to manipulate in order to keep up appearances.
5. **Depreciation Index (DEPI):** This is measured as the ratio of the rate of depreciation versus prior year. A slower rate of depreciation (DEPI greater than 1) may mean that the firm is revising useful asset life assumptions upwards, or adopting a new method that is income friendly.
6. **Sales, General and Administrative Expenses Index (SGAI):** This measures the ratio of SGA expenses to the prior year. This is used on the assumption that analysts would interpret a disproportionate increase in sales as a negative signal about firms future prospects
7. **Leverage Index (LVGI):** This measures the ratio of total debt to total assets versus prior year. It is intended to capture debt covenants incentives for earnings manipulation.
8. **Total Accruals to Total Assets (TATA):** This assesses the extent to which managers make discretionary accounting choices to alter earnings. Total accruals are calculated as the change in working capital accounts other than cash less depreciation.

Source: <https://www.businessinsider.com/the-beneish-m-score-identifying-earnings-manipulation-and-short-candidates-2011-5>

Confidential & Proprietary

THE BENEISH M-SCORE (Continued)

CALCULATION OF THE M-SCORE AND ANALYZING RESULTS

$$\text{M-Score} = -4.84 + 0.92 \times \text{DSRI} + 0.528 \times \text{GMI} + 0.404 \times \text{AQI} + 0.892 \times \text{SGI} + 0.115 \times \text{DEPI} - 0.172 \times \text{SGAI} + 4.679 \times \text{TATA} - 0.327 \times \text{LVG}$$

- If M-Score is less than -2.22, the company is unlikely to be a manipulator.
- If M-Score is greater than -2.22, the company is likely to be a manipulator.

Source: <https://www.businessinsider.com/the-beneish-m-score-identifying-earnings-manipulation-and-short-candidates-2011-5>

Confidential & Proprietary

POLLING QUESTION 2

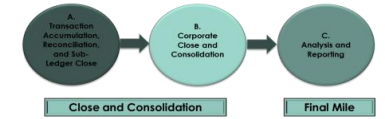
- 2. Are you concerned about financial statement fraud at your company?**
- a. Yes, we don't have strong internal controls and analytics
 - b. No, we have strong internal controls and analytics



1) MEASURING OPERATIONS AND 2) METRICS FOR FINANCIAL REPORTING

YOUR SCORECARD FOR THE FINANCIAL CLOSE

YOUR SCORECARD FOR THE FINANCIAL CLOSE



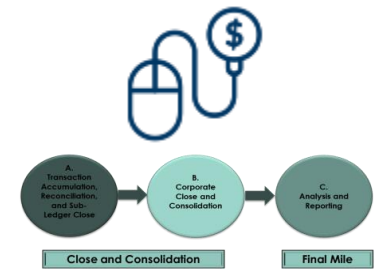
1. Measuring Operations



2. Measuring Financial Results



1) MEASURING OPERATIONS



1. **Gross Number of Adjusting Entries:** Transaction errors must be corrected, and their correction delays the closing process. Thus, investigating the gross number of adjusting entries can be used to track down issues that are delaying the close.
2. **Review Errors:** Note the types of errors found during the initial review of the financial statements. This information can be used to track down and correct underlying problems that can be prevented during future closing processes.
3. **Completion Times:** Further refine the duration of the closing process to focus on each category of activities that must be completed, to understand not only how long they take, but also how they are impacted by other steps in the closing process.
 - **Time to consolidate all general ledgers**
 - **Time to close the processing of period-end cash**
 - **Time to finish processing accounts payable**
 - **Time to issue billings to customers**
 - **Time to close payroll and record accrued wages**
 - **Time to count and value ending inventory**
 - **Time to issue related management reports**

A. TRANSACTION ACCUMULATION, RECONCILIATION AND SUB-LEDGER CLOSE



A.
Transaction
Accumulation,
Reconciliation,
and Sub-
Ledger Close

Volume of Entries Processed

- Number of journal entries processed per close end
- Number of journal entries per FTE
- Number of miscellaneous journal entries processed per close end

Cost per Miscellaneous Journal Entry

- Average cost incurred per miscellaneous journal entry input

Incorrect Information

- Yes/No metric indicating whether the company internally tracks wrong information

Submission of Incorrect Information

- Actual number of incorrect information from departments in a given period of time

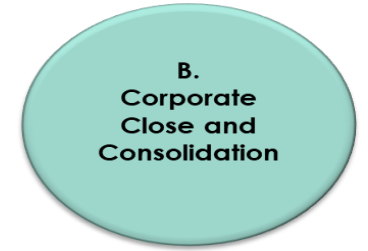
Submission of Untimely Information

- Actual number of untimely information submitted in a given period of time

Number of Discrepancies

- Number of discrepancies between the accounting system and the general ledger at month-end for book value, interest/dividend income, amortization of premium or accrual of discount, gain or loss

B. CORPORATE CLOSE AND CONSOLIDATION



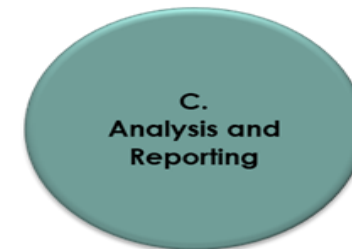
Volume of Submissions

- Number of areas/departments that gather, submit and route information that is used in the financial closing process (includes submission of information and gathering of financial data - not including finance department).
 - a) Cost Accounting
 - b) Tax
 - c) Investment Accounting
 - d) Investment Reporting
 - e) Actuarial
 - f) Other (Specify)

Frequency to Close the Books

- a) Monthly close
- b) Quarterly close
- c) Other (Specify)

C. THE FINAL MILE



Financial Close Teams

- Number of resources who are involved in reporting and analysis during the closing process

Peak Season Scheduling

- Yes/No metric indicating whether the organization provides peak hours scheduling to balance workload during the close.

Outsourcing/Insourcing

- Yes/No metric indicating whether the areas participating in the closing process outsource work to third-party resource (including finance department).

Temporary Hires

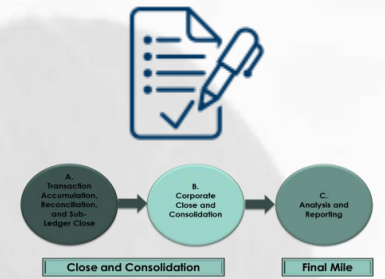
- Percentage of current workforce IN the areas involved in the closing process who are considered “temps”.

Manual Updates

- Average number of times information is updated during the closing process.

2) MEASURING FINANCIAL RESULTS

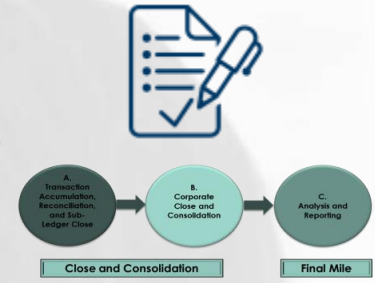
12 KEY METRICS TO INDICATE FINANCIAL HEALTH



1. **Real Revenue Growth:** Real revenue growth analysis shows the real annual growth in revenues adjusted for the effect of annual over-all increases or decreases in the gross profit index.
2. **Sustainable Revenue Growth:** Sustainable revenue growth tells us how much additional annual real revenue growth a business can handle according to the resources in the balance sheet.
3. **Pricing Policy and Pricing Index:** A good pricing policy is simply about maintaining your gross profit margin. Maintaining that specific margin is part of your brand identity.
4. **Operating Expense Control:** Operating expense control is management of the continuous financial obligations incurred in the daily operation of the business.
5. **Comparing EBITDA Versus Cash Flow:** When it comes to measuring cash flow to your business don't use EBITDA alone! Understand how useless EBITDA and compare EBITDA versus cash flow.
6. **Debt Free Cash Flow:** Use your cash wisely! Sometimes, the right move is to use your cash flow to grow the business, not pay off debt. Your debt free cash flow will show you how

2) MEASURING FINANCIAL RESULTS (Continued)

12 KEY METRICS TO INDICATE FINANCIAL HEALTH



7. **Excess Cash:** Excess cash management can harm the company's performance in many ways. It's not just having too little cash, it is also having too much
8. **Return on Assets (ROA):** Return on assets eliminates the effect of leverage when a business uses debt financing. ROA is highly useful in comparing one company to another.
9. **Negative Working Capital vs Positive Working Capital:** Knowing the potential need for negative working capital (as well as positive and neutral) is important for determining the future financing of a business
10. **Use of Debt Financing:** Debt financing is often far cheaper than equity financing, even in the worst of times. Use of debt financing plays a big role in cost of capital as well.
11. **Net Trade Cycle:** Net trade cycle calculates how many days and dollars are tied up in accounts receivable and inventory and furnished by the accounts payable.
12. **Cost of Capital:** The cost of capital gives us a benchmark for improving the value of a company; the returns we get on our assets needs to beat the cost or we're in trouble.



1) MEASURING OPERATIONS AND 2) METRICS FOR FINANCIAL REPORTING

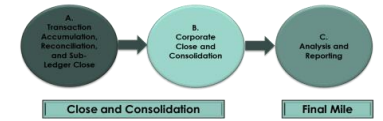
10 BEST PRACTICES TO IMPROVE YOUR FINANCIAL CLOSE

POLLING QUESTION 3

3. What creates the largest bottleneck in your closing process?

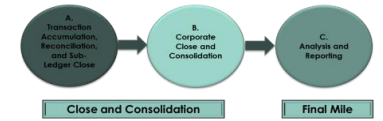
- a. Manual processes and spreadsheets
- b. A complicated financial infrastructure
- c. Time to complete reconciliations and resolve discrepancies
- d. None of the above

10 BEST PRACTICES TO IMPROVE YOUR FINANCIAL CLOSE



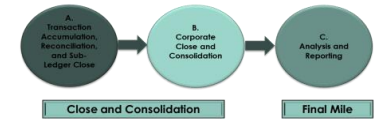
1. Document the Process
 - Document all steps of the closing process and ensure all those impacted by the close are trained.
 - Communicate the importance of the close and the critical nature of financial reporting.
2. Move Routine Work Out of the Closing Crunch and Complete Standard Allocations in Advance of the Close
3. Create Templates for Recurring Reports
4. Use Accruals and Estimates to Shorten the Close
5. Crosstrain Accounting Personnel
6. Minimize Journal Entries During Closing and Reduce Investigation Levels

10 BEST PRACTICES TO IMPROVE YOUR FINANCIAL CLOSE (Continued)



7. Move Routine Inter-Company Accounting Issues Out of the Close
8. Establish Clear Accountability and Checklists. Examples are:
 - Financial Close Checklist by Process
 - Executive Level Checklist
 - Disclosure Checklist
 - General Ledger (GL) Journal Entry Checklist
 - Financial Close Consolidation Checklist
 - Quarter-End Closing Checklist
 - Year-End Closing Checklist

10 BEST PRACTICES TO IMPROVE YOUR FINANCIAL CLOSE (Continued)



9. Assign Responsibility for Resolving Discrepancies
10. Develop Partnerships across Departments to Resolve Recurring Cross-Functional Issues and Monitor Results and Metrics
 - Develop Obstacles to the Closing Process Reporting and Tracking
 - Establish Post Close Reviews

POLLING QUESTION 4

- 4. Which of the following best practices would improve your closing process the most?**
- a. Document the process and define roles and responsibilities
 - b. Implement closing checklists
 - c. Process automation
 - d. Standard reporting templates
 - e. Metrics and analytics

Q&A SESSION





THANK YOU

CORPORATE HEADQUARTERS
15851 Dallas Pkwy, Suite 900
Addison, TX 75001
+1 (800) 416-0075
+1 (972) 701-9802

VP Marketing
Jonathan White
Jonathan.white@trintech.com

[TRINTECH.COM/CADENCY](https://trintech.com/cadency)

Confidential & Proprietary