Reducing financial reporting risk
It's more than fixing financial controls

"Concerns over financial statement accuracy cause stock price to plummet"
"Credit ratings drop following restatement of earnings"
"CFO and Controller ousted in wake of financial misstatement fiasco"

While these example headlines are certain to grab the attention of any finance executive, given the increasing responsibilities of today's finance executive, how many have set aside time to fully understand the state of financial reporting risk at their organizations? Financial reporting risk can be pervasive anywhere in an organization and can arise from an event or condition, external and internal factors, and decisions and choices made by many within the company. Financial reporting risk may also arise from inaction.

Today's CFO faces a heightened level of risk due to:

- Increasingly complex business models
- Mergers and acquisitions
- Globalization
- Decentralization
- Third-party administration
- Evolving accounting and financial reporting requirements

Compounding these issues is an economic environment in which organizations may try to do more with fewer resources.

Finance, in its myriad organizational iterations, whether accounting, financial operations, treasury, etc., is often an 'also-ran' to sales, service, marketing, R&D, and production in terms of investment dollars. At the same time, boards, the C-suite, investors, and regulators may insist on more detailed reporting while reporting deadlines and time frames have experienced compression.

In some environments, finance is ill equipped to deliver the data requested on a timely and transparent basis.

Because of these and other issues it becomes critical that, in addition to their other responsibilities, CFOs take the time to apply a people, process, and technology perspective in evaluating their financial reporting risk. CFOs need to understand the ways in which people, process, and technology individually and collectively contribute to aggravating or mitigating financial reporting risk for their organizations and determine what changes can be implemented to reduce that risk.

Financial reporting can be grouped into three major components:

- A variety of ***people*** responsible for extracting, assembling, aggregating, and analyzing data
- The ***processes*** and timelines by which this data is obtained and reported
- The ***systems*** that crunch the financial information and distill it into meaningful form

Characteristics of each of these financial reporting components can be a potential weakness that increases financial reporting risk or a possible strength that reduces financial reporting risk. By posing some general questions to managers in these areas, a CFO may develop a fairly clear picture of the current state of an organization's financial reporting risk.

People and organizational considerations

It is typically the job of the CFO to understand clearly and explicitly the risks to timely and accurate financial reporting. People, of course, are key. Among personnel issues affecting risk are headcount, training, skills, motivation, teamwork, and effectiveness. Processes and technologies can be implemented to function in an efficient and effective manner.

Artificial intelligence has not yet removed the human factor, meaning that virtually all stages of data gathering, analysis, reporting, and evaluating requires a human interface. In fact, when asked to name the top factor contributing to financial reporting risk at their organizations, one-third of the 3,000 finance professionals polled in a recent Deloitte webcast answered "people and organizational constraints and limitations." It is therefore prudent to closely examine the people factors that influence financial reporting risk.

People and organization considerations
Mini case study — I

Business issue:
A multi-state electric and gas utility experienced serious issues within its financial reporting unit. While no major restatements were needed, almost one third of the senior staff were eligible for retirement. The hiring process was cumbersome and time consuming. Limited career opportunities and a stressful work environment led to an attrition rate approaching 30-40 percent.

Organizational response and result
At the advice of Deloitte consultants, the utility realigned the corporate accounting structure under a "steward," "strategist," and "operator" model. They initiated a portfolio of talent programs including flexible working arrangements, career paths, a 360-degree feedback program, rewards and recognition, a learning and on-boarding curriculum, workplace planning tools, and critical job documentation.

Rebuilding the unit in this manner improved performance dramatically while maintaining existing staffing levels.

How clearly are roles defined?
Disability insurance carriers, in working with employers to develop return-to-work programs, have long known that many organizations are lax in their ability to provide job descriptions. In the financial close and reporting process, poorly defined roles are typically a major red flag. There may be gaps in roles and responsibilities leading to failures to obtain, process, or analyze information. If there are overlapping roles, conflicting information may arise. An aggressive and ongoing review and analysis of roles and procedures may identify and rectify areas of overlap and conflict.

How closely do skills align with responsibilities?
Recruiting, training, and mentoring people with financial analysis and financial reporting responsibilities are critical tasks. Organizations are dynamic entities in which employees transfer, get promoted, resign, or otherwise change their functional behavior. In addition, businesses experience ongoing change in their processes, strategies, and direction. Are the right people performing in the right roles? Is there ongoing training or refresher coursework to help assure that your financial control professionals are abreast of current regulatory and accounting requirements, not to mention up-to-date with current leading practices to meet those requirements? Finally, do these individuals know the business and how it operates with a depth of understanding to raise the right questions in the face of potential "red flags"? Financial reporting acuity involves a great deal more than regulatory knowledge and an academic understanding of generally accepted practices.

Do you have enough people?
Are there too few doing too much? The financial reporting side of the organization is in competition for resources with the very profit centers about which it is reporting. As a result, overworked, under-appreciated personnel may make mistakes or not complete essential activities. In this same vein, formalized career paths, mentoring, rewards, and recruiting strategies for finance should be an integral part of the overall people-management function of the enterprise.

What is the state of intra-organizational communication?
The CFO defines the manner and tone, even the integrity of intra-organizational communication about financial controls and reporting. Are there regular top-down communications from the CFO or an executive of sufficient seniority about the importance of financial control-related activities and their critical role in preserving both the brand and the public perception of the company? How well do senior management, the board and its committees understand the financial reporting processes of the company beyond that which affects them directly? The CFO is typically in a position to educate those at the highest level of the organization about how controls over financial reporting risk can facilitate or derail broader corporate strategy; and be certain that this knowledge is disseminated throughout the enterprise.

Communication of controls applies horizontally across those departments or units responsible for the data to be aggregated, analyzed, and reported. Because key business processes traverse departments, and business units' key control activities should be applied consistently and effectively across the process to facilitate the timeliness and integrity of business results, internal training should provide an integrated view of how controls need to be performed so overall financial expectations are realized.

Finally, within the unit (hopefully singular) responsible for communicating financials, how well controlled and managed is the communication of financial information? Is there a structured approach that contributes to financial information being complete and accurate such as calendar milestones against which activity can be checked? Are there checks against processes including closing, reviewing, classifying, and analyzing? Most importantly, is there a specifically identified person ultimately responsible for final approval?

When was morale last surveyed?
Because clear roles, responsibilities, skill, and communication are critical to financial reporting controls, answers to the questions above will be a fairly accurate bellwether to the state of morale within the financial reporting area. Absent commitment, motivation, and engagement, a few "close enough" journal entries can add up to "not close enough" and lead to a misstatement and disastrous result. If, however, employees are engaged, understand the role they play in the organization, and feel appreciated for the responsibilities they have assumed, reporting accuracy, timeliness, and auditability can soar.

Process and policy considerations

Organizations have never before faced the complexity of current business models or the global reach of business operations and extended relationships. Functions routinely handled within the organization are increasingly outsourced to third parties around the world, whether call centers or payroll administrators. Mergers and acquisitions bring disparate systems, approaches, and cultures together. And it is the CFO who is typically expected to reconcile the issues as they pertain to reporting the financial results of the organization.

In the past, financial reporting "fixes" could be cobbled together manually. But with rapidly evolving accounting and financial reporting requirements, such ad hoc or point solutions may no longer work. As one financial sage suggested around reporting regulations, "The books are getting thicker, the pile's getting higher, and the text is getting smaller."

A review of policy and processes may yield surprising results.

To what degree are processes automated?
At the time a reporting period closes, the clock begins ticking on a variety of time-critical tasks that must be executed accurately and efficiently. Automatic triggers, reminders, escalations, and status reports that are generated for management in an organized, planned process may be indicators of the health of the financial reporting process.

Are standards in place across the enterprise?
Mergers, acquisitions, global reach, and demands for information both internally and externally make implementation of a standardized approach to financial reporting extremely difficult. At the same time, widely dispersed centers of activity can be very difficult to bring under the umbrella of a centralized financial reporting operation. Absent such standardization, however, risks may be magnified exponentially in attempting to shoehorn variant approaches to accounting, reconciling, analyzing, and reporting.

How many chefs are stirring the pot?
A number of issues may arise in financial reporting when everything is filtered through many layers, hands, committees, and approvers as they work their way up the organizational ladder. The process is slowed; accountability is diluted; and communication between parties may become muddied and prone to error. Shared responsibility conceptually is attractive. It can also be a synonym for responsibility denied with an attendant failure of effective governance. Roles at every stage from aggregation to analysis, reporting, and approval should typically be spelled out clearly. Many of these risks can be ameliorated by creating a strong, centralized management of financial reporting.

Process and policy considerations
Mini case study — II

Business issue:
A large financial services firm was struggling to provide timely and controlled financial reports. A close process that could last up to two weeks was not only painful, but led to numerous adjustments and corrections needing to be posted during the "locked-down" days of the close. Finance was simply not communicating with other parts of the organization.

Organizational response and result
A "Close Czar" was appointed to instill project management discipline during the close period. Closing efforts were spread throughout the month. Non-key activities such as reserve and subscription accounting were moved to the middle of the month. Routine, planned, and standardized processes were instituted. The result was a close process reduced to 6-7 days with greater transparency to financial information available across the organization. Time was made available for more value-added activities with a dramatic improvement in accuracy, morale, and, and performance.

Where are the benchmarks, performance measures, and documentation?
Milestones, benchmarks, audit trails, and performance measures are not only critical to reducing risks associated with financial reporting; they may be the best way to get a handle on where greater attention and diligence is needed. Documentation is a given. The quality of documentation is more than regulatory compliance however; it is a tool from which critical data can be derived and organizational decisions, and change, effected. The CFO typically plays a key role in determining what should be documented, and how automated processes can be installed to facilitate accuracy and completeness.

Systems and information considerations

Information systems — the software and hardware that globally unite people and processes for financial reporting to a common end — accurate, timely, and compliant disclosure.

Information systems — the software and hardware that may frustrate people and processes at every site struggling to produce financial reports leading to chaos, misstatements, restatements, and regulatory non-compliance.

Both of those statements have probably resonated with almost every CFO at one time or another.

Hardware and software are, in and of themselves, neutral and inert. In the environment in which businesses function today, they may be critical tools that may assure the people and process components of financial reporting function seamlessly and synchronously — or not.

A CFO, while rarely an IT or systems expert, needs to be confident that accounting functions and controls operate as intended and that employees know how to use the system as it has been designed so results are as expected or errors are identified in a timely fashion. Questions for a CFO to ask are not as simple as some of those raised above for people and process components. But there are similarities.

Manual or automated? Complicated or intuitive? Manual controls or automated control?
These are some of the exact questions asked of people and processes. This is because it is information systems that may request, acquire, aggregate, digest, reconcile, and report the numbers over which the CFO is attempting to exert control.

If information is manually inserted into a system there may be risk. If numbers from disparate, incompatible operating systems or applications need to be recombined into another — there may be risk. Versioning issues arise. Questions may arise concerning accuracy. Even the objectivity of data may come into question if it passes through too many layers or hands.

If moving from manual to automated processes, what controls are in place to monitor the transition, while new or changed systems are installed?

Issues with technology systems and applications can be as confounding as any human carelessness or process bottleneck.

Leading practices

We have discussed ways in which an organization and particularly a CFO can assess financial reporting risk related to the people, processes, and systems of finance. Isolating the people, processes, and systems in discussions of financial controls and reporting is something of an artificial construct because they must typically work in seamless tandem to a common end. However, within each, leading practices can be identified that will go a long way to assuring an idealized end point; and it may be convenient to address them individually.

People and organization

A risk-aversive CFO would probably hope to find the following in place organizationally:

- Accountability and responsibility for financial reporting functions is clearly defined, assigned, and executed by all constituencies
- A finance employee retention strategy is clearly defined to meet business demands and match employee goals
- Employee skills and capabilities are continuously developed through training programs and redeployment
- The company is branded as a career destination for finance professionals
- People are hired based on their potential to achieve results, not just technical skills and previous experience
- Performance management programs are designed to effectively measure the performance of finance staff
- Key individuals from outside finance and accounting are involved in a disclosure and governance committee
- A baseline of financial literacy is instilled throughout the organization

Systems and information considerations

Mini case study — III

Business issue:

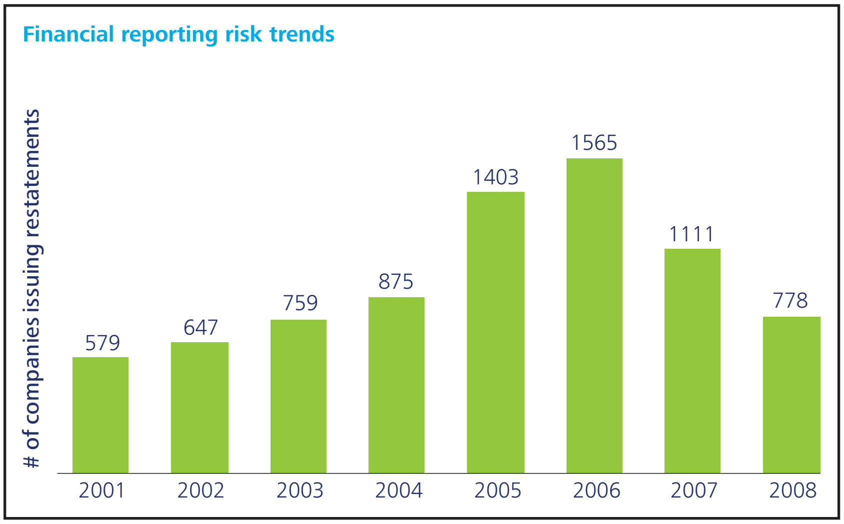
A global specialty chemical manufacturer with over $6 billion in revenues operated in more than 100 locations in 25 countries. It experienced a complex and extended close, consolidation, and reporting process with multiple systemic "hand-offs" resulting in a lack of controls across the organization. One insider reported that SOX results were "lukewarm" at best.

Organizational response and result

Older, disparate legacy systems were replaced with a global package for legal consolidation, financial/SEC reporting, and management reporting. This resulted in increased workflow controls with an improved audit trail and security. Standardizing reporting structures and reports improved data reliability and accuracy while substantially shortening the close cycle.

Process and policy

- Processes are automated and centralized to reduce errors and costs
- Well documented and enforced policies and procedures reduce issues of non-compliance and help finance execute complex transactions
- SEC reporting rules, policies, and procedures are easily accessible to the preparers and reviewers of reports
- Pre-close reconciliations and adjustments are performed consistently in a standardized fashion
- A Close Manager approaches monthly reporting with a "project" mentality, leading planning sessions before each close, using a full suite of project management tools and disciplines during the close, and conducting post-mortem review sessions after each close to discuss specific issues that arose and develop action plans to reduce their likelihood of recurring
- Reconciliation and analysis of balance sheet accounts is rapid and reliant on integrated, automated information
- Risk policies consistent with the organization's risk tolerance are understood, managed, and updated as necessary



Systems and information

- System-generated entries provide proper accruals
- Auto-reversing and auto-recurring journal entries require no manual interaction
- Intercompany transaction functionality is standardized
- Knowledgeable resources are readily available to support the financial systems
- Accounting and consolidation systems are integrated
- Automated interfaces collect all data elements to be included in financial reports, including metrics
- Exception reporting is leveraged to streamline analysis
- A streamlined standard chart of accounts is applied across the organization
- Audit trail capabilities are established for all reported information

The business case for reducing financial reporting risk

While it may be a little difficult to assign an ROI to reducing financial reporting risk, there can be little doubt that inaccurate financial reporting can have a significant negative impact on shareholder value. One needs only to look at restatement trends during the last decade to realize that negative consequences can be significant.

In addition to a loss of investor confidence evidenced by an associated share price decline, an organization may face a drop in credit ratings, and management changes may be effected. One study has suggested restatements can destroy up to 35 percent of an organization's worth.

Increasing the quality of financial information builds investor confidence and trust, facilitates performance management, and enhances decision making by management. Regulatory compliance can be improved and costs associated with external audits and review may be reduced by improvements in financial reporting processes.

By attacking financial reporting risk through thoughtful people, process, and system improvements, rather than merely increasing the number of financial controls executed, hard dollar savings can result in addition to the savings associated with reduced financial reporting risk. Maintaining high morale will reduce turnover and the associated costs of recruiting and training new employees. Automating processes may reduce labor costs associated with current levels of manual effort in the close process. Standardizing and integrating financial systems may reduce software licensing costs.

The key message is that effective financial reporting controls are not "merely" an administrative expense. They typically are integral to informed strategic thinking and the effective operation of an enterprise.

Getting it done

To be successful, an effort to reduce financial reporting risk should start from the top with the CFO taking ownership of the effort. Identify a project manager who understands financial reporting processes; assemble a cross-functional team of accounting, information technology, human resources, and operational resources; and launch an effort to determine in a clear-eyed, non-judgmental way where you are with respect to financial reporting risk. Determining "where you want to be" is further down the project path.

Financial close and reporting process maturity model

	Stage 1	Stage 2	Stage 3	Stage 4
Organization	• Key processes in the organization are not defined and are inadequate to effectively carry out close activities • Business units and Corporate function independently	• The key processes are informally and inconsistently defined and integrated across the organization • Communication and coordination is limited between business units due to dispersed geographic locations	• Processes are defined and integrated but errors are not traceable to an owner • Activities are relatively centralized with strong coordination between business units	• The core processes are defined, communicated, and assigned owners across the business • Activities are centralized and cost effective, with a high synergy between different business units
Talent	• Finance staff acts as data gathers, not data analyzers • Finance roles and responsibilities are not differentiated	• Finance staff has broad skills but requires cross functional training • Finance employees are recognized by their skill sets	• Finance staff is adequately trained and work is evenly distributed to address the needs of close and reporting activities	• Staff is continuously trained, focuses on data analysis and proactively manages key business decisions
Policy and process	• Policies and processes are not well developed, informal, and ineffective	• Policies and processes for preparing financial information are defined, but inconsistently executed	• Policies and processes for preparing financial information are integrated but are not completely automated	• Policies and processes are integrated, automated and accurate
Systems	• Systems and data architecture are not integrated and automated	• Systems and data architecture use common platforms, reducing manual entry and adjustments	• Reconciliation and financial analysis processes are executed quickly and rely upon integrated and automated information	• Systems are well integrated, customizable, automated and accessible through finance portals, with on demand access to assess performance metrics

Begin by interviewing associates and colleagues to learn their concerns and use this information to define a vision and target people, process, and system improvements that may reduce financial reporting risk.

- Identify, assess, and prioritize inherent and specific risk areas for your organization
- Diagram key elements of financial reporting processes, highlighting handoffs, approval trails, etc.
- Learn where there are gaps and overlaps
- Conduct interviews, workshops, and focus groups with participants whether producer, reviewer, analyst, or recipient of financial data
- Keep an eye out for, and document “quick wins” or “low-hanging fruit” where significant risk or cost reductions could be achieved

Finally, develop a future state design based on the assessment. While this idealized future state will evolve over time, it describes the desired characteristics of people, process and system components of financial reporting and typically incorporates:

- A pro-forma reporting calendar describing future financial reporting processes and roles
- Talent management programs to be developed
- Recommended new monthly financial reporting procedures
- Organization, process and system changes required
- System enhancements and organizational improvements that reduce financial reporting risk
- Change management and conflict resolution processes to be used during implementation
- Vehicles to monitor performance against objectives
- Performance measures to continually monitor the effectiveness and efficiency of the changes effected

The bottom line

Reduction of risk in financial reporting can be similar to many other business processes. It should be undertaken systematically and with clear goals that are frequently "reality-tested" to assure processes are up-to-date and appropriate. The entire process needs to be broken down into its smallest manageable components. At the same time, affected employees — from finance and information technologies to human resources, sales, and operations should be "joined at the hip."

Business needs drive technology solutions. This is a message that is sometimes lost in the relentless, sometimes overwhelming emergence of technological solutions to problems real and imagined.

Perhaps the most important point is that progress and results may need to be analyzed, assessed, reconfigured, and adjusted continuously.

The true bottom line lies with the CFO. For the CFO is ultimately responsible for the quality and timeliness of an organization's financial reporting process. The CFO holds a critical position — interfacing among the CEO, the board of directors, investors, and regulators with respect to financial reporting information and compliance. The CFO should champion improvement in the people, process, and system components of finance to reduce financial reporting risk while improving the effectiveness and efficiency of the financial reporting process. And the CFO will do this for a very good reason — the CFO's job may very well be on the line.

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