FIXING THE FINANCIAL CLOSE

WHITE PAPER

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Introduction

The financial close is the most vital of all accounting department processes. Then why do so many accounting departments struggle through it each month unprepared?

Would you continue taking your tax return to an incompetent accountant? Then why are organizations so forgiving with accountants that prove every month they are incapable of performing an accurate, timely financial close? It usually only takes one inaccurate, poorly prepared tax return before you stop going to or recommending an accountant for tax work. Then why do so many companies allow their accountant/controller to stagger through the close each month as though it's a surprise?

At a *minimum*, corporations should demand the same level of competence and professionalism from their accountant/controller as individuals do from their tax preparer. It's a simple comparison. An industry accountant that can't close the books is the equivalent of the tax accountant that can't prepare a return.

Background

Subpar financial closes transcend organizations of all industries, sizes and cultures.

Family businesses tend to trust only family members. What happens when you have a family member running the accounting department without proper training or experience? Who wants to fire or replace their father, mother, son, daughter, nephew or niece (not to mention in-laws) because they can't do their job?

How about organizations mandating "Big 4 experience" during candidate searches? Technical competence is a must, but can they make the transition to industry? How about managing a staff *not* solely comprised of well-educated young professionals willing to do anything in the name of career advancement? Do they have the "people" skills? Can they communicate effectively with IT? Purchasing? Sales? Shipping? Effective financial closes depend on strong processes affecting multiple departments.

Some companies wear the commendable strategy of "promoting from within" as a badge of honor. What happens when companies refuse to look outside for skills they lack inside? Betty the Bookkeeper may be a model employee and the sweetest person you ever met but is she capable of managing a complex financial close?

Not all these situations end badly. People adapt and grow professionally all the time. This paper addresses the times these situations fail – usually miserably. Potential for failure is not limited to the situations described above. Rather than listing more, I'm assuming most of you have already seen *at least* one of these dynamics at work. In that case, you were probably nodding as you were reading!

After business owners or senior executives decide on a candidate, every effort is made to support that decision. Subordinates aren't going to shatter the illusion. The new hire is often the top financial officer in the company. Nobody internally can evaluate performance (even the owner/senior executive). Intuitively ownership and senior management knows there is a problem. They hire consultants. Meet with outside auditors. Even after spending thousands and receiving confirmation from external sources, the owner/senior executive is slow to act (if at all).

It's human nature to deny making a mistake. That's why so many companies ignore the situation and suffer through inaccurate, incomplete financial closes. Doing nothing is the path of least resistance and the easiest on their ego.

The root causes behind poor financial closes usually fall into one (or a combination) of the following categories:

Leadership
Staffing
Enterprise Resource Planning (ERP) Conversions/Setup/Maintenance
Communication

As I've already intimated, leadership is a *must*. Until you get a competent leader in place, you can forget about getting control of the financial close.

The premise of this paper is that successful financial closes revolve around people and processes. Hire the right people. Continuously improvement processes. Embrace and leverage technology. Communicate effectively with operational departments. These are the building blocks to "Fixing the Financial Close".

Leadership

It's amazing how many accounting departments operate without a formal closing process replete with schedules and checklists. You will *never* significantly improve the closing process

without first adding structure. Depending on the size and complexity of an organization, there can be hundreds of steps (crossing multiple functions) required to produce an accurate financial close. Creating a blueprint that focuses all resources on the task at hand is leadership 101.

Most of us have observed accounting departments operating without a structured process. You know these organizations when you see them. Stress levels run high while the nights run late. Transactions get recorded twice, once, or not at all. Prior month accruals don't get reversed. Preliminary numbers are often sent to executive management without fully knowing what is included. The embarrassing admissions soon follow. "Oops, depreciation is not booked". "Sorry, the commission accrual is not in". "They are still working on percentage of completion". "I'm not sure if WIP is in, I'll have to check". "Nobody reversed last month's payroll accrual". Sound familiar?

Let me state the obvious. Organizations like the one in the previous paragraph have a leadership problem. Have you ever heard of a controller/accounting manager described as "not being a people person"? Precisely the reason a schedule/checklist is absolutely necessary. For the "non-people" person, schedules and checklists help with communication.

People usually rise to management positions based on technical competence. Not all technically competent professionals make great (or even adequate) leaders. Competent leaders don't allow critical processes to drift through chaos month after month. The incumbent might have the capacity to be a leader, but without experience and guidance they will continue down the same destructive, disorganized path.

Poor leaders have a hard time "letting go". Every key process or decision bottlenecks with them. They don't trust staff to perform even basic tasks. They are condescending and micromanage. The worst of the breed is too insecure to delegate responsibilities fearing it diminishes their perceived job security. Weak leaders are extremely defensive when challenged or questioned. They limit subordinate contact with outside departments. *Everything* must run through them!

Keeping these leaders in place has consequences. Quality professionals won't work for inept leaders very long. Turnover ensues with the most capable usually leaving the fastest.

In 1970, noted author Leo Rosten said it best - "First rate people hire first rate people while second rate people hire third rate people". You either have constant turnover as the qualified hires leave or a mediocre staff that can't leave because their skill sets are not marketable. That's just the way the worst leaders like it – surrounded by non-threatening subordinates incapable of challenging authority. Doubtful your closing process improves in either scenario.

Mediocre leaders reject succession planning and staff development. The dysfunction is by design. They use it to maintain power and control. They reject structure and discipline. Nothing changes with this type of leadership – guaranteed!

Step one to fixing the financial close is ensuring you have the right leadership in place. If you give incumbent leadership one last chance, you need to monitor progress with timelines and deliverables. You've heard the litany of excuses too many times before. Stop believing them!

You may decide to support incumbent leadership with temporary strategic or tactical support (or both). Make sure the cost and length of this support is in your progress plan. Allowing it to go on indefinitely only continues enabling ineffective leadership.

You may replace incumbent leadership with an interim professional. Again, have a plan with timelines and deliverables. Using an interim professional to "stop the bleeding" and start building structure is a viable option. You need somebody who is not easily intimidated and can produce results immediately. Utilizing an interim professional allows you to work on a solution immediately while searching for a permanent leader. The eventual transition to a permanent leader is smoother. Improvements are already taking hold and the interim professional can prove a valuable resource to the new hire.

You may go directly to hiring a new permanent leader. I would advise this choice only if the candidate has experience in a similar situation. This is not a game for the meek and certainly not a good place for on-the-job training.

Fixing your financial close starts with fixing deficiencies in leadership.

Staffing

Obviously the leadership described in the prior section impacts staffing. I've already discussed some of the implications. In this section, let's assume the leader is capable and competent but limited by unrealistic budget constraints or expectations.

Many of us have worked with small businesses growing faster than their support capacity. In the early years, relying on outside accountants or a bookkeeping service for the financial close is common place. Sooner or later (usually grudgingly) an in house accountant is hired to run the accounting department. As the company grows, hourly non-degreed clerical staff is added to handle the transactional work load. Many business owners don't understand the accounting function. They see no difference between a controller, an accountant or an AR clerk – "they all do accounting". In many cases they are still complaining about what they are paying their Accounting Manager/CFO/Controller! Needless to say, they usually aren't receptive to paying professional level wages for "overhead".

Let's look at the complexities associated with a growing company.

1) **Financing.** As the company grows, either organically or through acquisition, additional financing is often needed. It takes time and expertise to write forecasts, bank plans and perform compliance reporting.

2) **Acquisitions.** Requires integrating an existing ERP system into yours or keeping (and learning) the acquired ERP system. Requires learning business processes unique to the acquisition and incorporating into your processes.
3) **Complexity.** Commission plans become more sophisticated. The sales department employs ever increasing creativity to drive growth - drop shipments, outside agents, consignment, etc. Inventory goes from 100 SKU's to 20,000 SKU's. You added manufacturing to a distributorship. Added a leasing component. You have international subsidiaries and deal in multiple currencies.

We could go on all day but I'm sure you get the picture. How does one professional support all these initiatives and perform the financial close timely and accurately all by themselves? Sooner or later you need help. No matter how competent you are or how tight you run the ship, you reach a point of maximum capacity.

I've seen $800 million a year companies still trying to run like a mom and pop shop. A controller, an accounting manager, and ten bookkeepers masquerading as accountants. Would you want to make decisions based on the numbers that outfit produced each month? What happens to their financial close process when the controller quits? Quits after months of working late nights and weekends. Quits after losing a candidate over a $2,000 difference between the ask and the offer (the owner wouldn't budge). Been there?

The quality and competence of staff needs to keep pace with company growth. You only get there by hiring experienced, degreed professionals able to perform currents tasks and possessing the capacity to learn and grow. The best professionals embrace change and thrive when challenged. Provide appropriate mentoring and realistic career advancement prospects and the core staff remains intact.

Don't settle for a staff that can't troubleshoot/solve problems, can't perform advanced excel functions, refuses to learn new software applications and most of all – doesn't make your workload any easier. Have staff members cross trained whenever possible. Make sure all key processes are documented with detailed work instructions. Don't allow staff members to hold you hostage by not sharing knowledge with the rest of the team.

A marginal staff running inefficient processes translates into ***higher costs.*** What does the organization get for these higher costs? Nothing! One measure of an accounting department's success is how cost effectively they process repetitive, non- value added transactions. Time is better spent analyzing performance and providing decision support to operational departments.

Allocating additional resources to an underperforming department with poor leadership is not going to fix the problem. In most cases you only create more chaos while adding more cost. The choice is clear. You can continue treating symptoms (and get nowhere) or make choices that cure the disease. Like everything else in life, you get what you pay for when it comes to

staffing. You need to be *at least* market competitive with your compensation if you want to attract top talent.

Attracting top talent is only half the battle. Retaining and developing them is the other half. According to managed human resources staffing partner Jumpstart:HR, "The cost of employee turnover can range from **40-400%** of an employee's annual salary. The total cost of turnover includes money, time and other hidden or "soft" costs, which when combined, are often much more substantial than expected."

Recruit, develop and reward a staff you want to keep intact for years.

ERP Conversions/Setup/Maintenance

Marginal professionals find ways to survive in static environments. The same is not true of changing, dynamic environments. Many times the catalyst for change is moving to a new ERP system. The work instructions of the last 5, 10 or 20 years become obsolete. The screens and processes are different. Not so different a skilled professional can't make the transition – but too radical for individuals used to performing tasks by rote without understanding the underlying transaction.

Most of us have been through at least one ERP implementation. In a well planned implementation, adequate resources are allotted so that internal people own the various modules and the staff receives adequate training before going live. In far too many cases, external consultants perform the majority of the implementation based on information received during a "needs analysis" phase. Minimal internal participation with limited training follows. By the time the system goes live, nobody owns it, nobody wants it and worst of all – nobody understands it!

The focus here is not to discuss the right versus wrong way to implement an ERP system (although lack of participation from accounting is often a contributing factor in a bad implementation). Whether the implementation is successful or unsuccessful, the work still needs to get done. The financial close still happens. Have you ever seen an accounting department attempt a financial close after an unsuccessful ERP implementation?

In a good implementation, you ensure every report and piece of information you need for the financial close can be accessed in the new system with "how to" work instructions. You understand which processes need to run and how to run them. You are willing and able to research and interpret documentation. Even in a spectacular implementation, there will be a learning curve.

What does a bad implementation look like? I've seen companies take *months* to perform their first financial close after an implementation. No financial statements get produced. Operational departments get none of the reporting they need. Payables back up leading to suppliers cutting off deliveries. Inventory variances abound because nobody understands the

underlying transactions (or set up). Your audit costs three times the normal amount (and takes three time longer) because you can't produce audit requests timely or accurately.

It's not long before the turnover starts. Those with qualifications leave for greener pastures. Guess who stays behind? The staff that barely functioned on the old ERP system. How effective do you think they are now? How much effort will they put into learning or fixing the new system?

Needless to say, the performance of the ERP system will not improve without intervention. When the auditors come knocking, they expect the person running the accounting department to understand the ERP system and how it processes transactions. This requires reading documentation and testing setups. You work closely with the IT department, software consultants and various module owners.

Getting the ERP system functional after a botched implementation is not easy. In my experience, correcting a bad implementation with the same leadership and staff (that allowed it in the first place) is next to impossible. You need the right people. Once that problem is addressed, you need to make fixing the ERP system a top priority. You won't get far in a car that's not properly maintained – and you won't improve your closing process with an ERP system that's not properly maintained.

Today's IT department is not structured to own operational department ERP modules. They are not subject matter experts in purchasing, inventory, accounting and sales. Those departments are responsible for setting up and maintaining those ERP modules. It's not uncommon to see those departments lacking the knowledge (or ambition) to setup and properly maintain ERP modules. The transactions coming out of those modules hit the general ledger. Who is responsible for the general ledger? Who will the auditors question when verifying these transactions?

The accounting department can't be a spectator when it comes to ERP maintenance. Setting up the chart of accounts and calling it a day won't cut it. The accounting department needs to be involved because they own the numbers - regardless of how they got there. It's no coincidence that many organizations (depending on size) have IT reporting to the CFO. In addition to facilitating cooperation, it conveys an organization wide message that accounting/finance has every right to be involved with ERP setup, maintenance and operation.

Need more proof? Look at how audits have changed in recent years making the IT function an ever increasing portion of the total audit. According to a recent Microsoft Dynamics NAV blog, "when referring to their ERP systems, it is pretty common that customers refer to it as *accounting software*." While accounting functionality is only an embedded part of the total ERP system, this widely-held perception reinforces the notion that accounting owns the output.

Communication

Break downs in communication occur inside and outside the accounting department. Going back to leadership, a formal schedule/checklist goes a long way in communicating tasks and timelines. While a schedule/checklist is an invaluable part of the financial closing process, a schedule/checklist alone will not solve communication gaps.

Poor communication is usually not a phenomenon that occurs only during the financial close. In all likelihood, it's the everyday modus operandi. In the most challenging environments, poor communication is a company-wide trademark.

Have you ever experienced the following problems?

- Shipping department processes impacting your invoicing cutoff
- Purchasing processes affecting your goods received not invoiced report
- Month end reports scheduled and run by IT not processing timely/accurately
- Order entry not entering commission percentages correctly
- A sales department that doesn't complete paperwork in accordance with policies
- A manufacturing department that doesn't close jobs timely/accurately
- Construction in process not closed timed/accurately

All these events affect your ability to perform the financial close. You need to meet with the departments/individuals responsible for the bad/broken process. One thing is guaranteed - nothing will change unless you meet with them. In all likelihood, they don't even realize the downstream impact of their current process. You need to take the initiative.

Similar to the ERP section, the accounting department doesn't have the luxury of being a wallflower when it comes to communication. If it's broke – you need to fix it. It's the accounting/finance function taking the hit for weak internal controls (i.e. weak processes).

Don't buy the stereotype that accountants are introverts that don't communicate well with others. Claiming to be introverted doesn't absolve accounting from responsibility. Fixing broken processes is an accounting initiative.

It goes back to staffing. Core personalities are hard to change. An introvert is an introvert. Your hiring process should place a higher premium on candidates who have demonstrated the ability to communicate cross functionally. You can have stellar performers with introverted tendencies, but the accounting department as a whole *must* possess strong communication skills.

CPA and eHow Money contributor John Freedman writes , “With nicknames like "number-cruncher" or "bean-counter," you might think that accountants don't need communication skills at all. However, the introverted, socially inept vision of a nerdy accountant is as outdated as the visor that he is pictured wearing. Modern accountants need communication skills in order to communicate their findings to those who make decisions, and understanding some common accounting communication shortcomings is a good way to figure out where you may need to improve.”

Conclusion

A successful financial close depends on people and processes. People can be motivated, trained or replaced. Processes can be tweaked, re-engineered or eliminated. There is no reason to accept a dysfunctional, stressful financial close as unavoidable or normal.

Start by addressing the leadership void. Support existing leadership with resources or replace it altogether. Build a staff that is motivated, trainable and promotable. Create a department of problem solvers with exceptional communication skills. Embrace technology and automate outdated, inefficient processes.

Get the right building blocks in place. Create a plan and start on a path of steady improvement. The change won’t happen overnight, but gradually the monthly financial close will get easier, more accurate and certainly less chaotic. Reporting improves, letters from compliance agencies stop and audits are no longer feared.

About the author…

John (Jack) R. DiMatteo is an active Ohio licensed CPA. He possesses over 20 years of finance, operations and technology experience across multiple industries. He provides strategic and tactical support to underperforming accounting departments and business operations. Prior engagements include interim CFO/Controller services, ERP implementations, decision support, process improvements and project management. He is President and CEO of Executive Overdrive LLC, a professional services firm providing organizations with the extra horsepower to get things done.

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