

# THE FAST CLOSE

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WHITEPAPER

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### ABSTRACT

**Many organizations are attempting to improve the efficiency of the process by which they close their books. Most financial systems are built to report on historic costs; however, the trend is toward more subjective measures, such as fair value accounting. Process improvements to the financial reporting system are suggested to deal with this new reality.**

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**M**any companies are attempting to speed up the process used to close their accounts. The fast close promises a significant reduction in cost as well as more timely information delivered into the hands of decision-makers, including company shareholders. Some companies, such as Cisco, have gone beyond the fast close to a virtual close, whereby the books are closed almost in real time. Most companies, however, remain stuck with a process that is an unhappy marriage of systems held together with spreadsheets and manual overrides.

For companies seeking to improve their reporting processes, it is helpful to start with the types of systems that are involved in this effort. Generally speaking, there are three kinds of accounting systems used to close the books and report earnings:

- Ledgers that track and store the vast majority of transactions arising out of business operations
- Consolidation packages that rollup information from the ledgers and other sources
- Various middleware tools that pull data from a variety of sources to complete analytical tasks, such as footnote disclosure.

Ledgers are the foundation of any accounting system, providing the core of “hard” numbers, such as sales and expenses. Ledgers are the system of record that captures individual transactions that, taken together, present a picture of the business operations. During the close, the ledgers have to be verified by certain external data points, such as bank statements and shipping records, to confirm that the recorded balances are correct. Adjusting journal entries are made to ensure the integrity of the ledgers.

The ledgers are then rolled up into a consolidation system that normalizes the data for higher level reporting. So that, for example, European sales recorded in a different ledgers can be added together and disclosed alongside sales from other regions. Here, too, it may be necessary, to validate the data by reference to sources outside of the ledgers.

Lastly, there is middleware that pulls data from ledgers, consolidation packages and various other sources for analytical purposes. A good example is the tax provision, which requires pre-tax book income from the consolidation, low-level details from the ledgers and supplemental information gathered from the field. Once all the data is loaded into the tax provision middleware (and reconciled to the consolidated figures), calculations can be run to support the disclosure required in the tax footnote.

Professional judgment plays a significant role in this, the final step of the process. Staying with the tax provision, the final results can be radically changed by a shift in judgment regarding an outstanding tax issue. These “soft” numbers often have a very significant impact on the figures presented in the financial statements and carry a high degree of risk – especially if the judgment of professional in question turns out to be wrong. In this case, it is critical to be able to retrace one’s steps and demonstrate the thinking that went into the assessment.

In order to improve the process, it is important to identify the “hard” and “soft” numbers generated by the system, as they behave quite differently. A company that has clean cut-offs for sales recorded in their ledgers may well produce solid “hard” revenue figures. But the same company could run into problems applying the “soft” revenue recognition principles required by GAAP, where a good deal of analysis and judgment is required. A company with strong inventory controls can produce a “hard” physical inventory, but can be deficient in setting up “soft” obsolescence reserves, which are often a matter of valuation. Likewise, a good trading system can generate reliable investment positions, only to fall short on marking those positions to market. Conversely, a process that is focused exclusively on “soft” numbers is built on sand.

Many of the issues around “hard” numbers can be cured by discipline; i.e. clean cut-offs and reconciliation procedures. Others require systemic change. So, for example, a company that has many different ledgers and subsystems with different charts of account will have multiple reconciliations and complex mapping issues, all of which will slow down their closing process. A company with one ERP package and a single chart of accounts will have less to worry about here. Achieving these benefits also requires discipline, as the addition and deletion of new accounts must be centrally controlled.

The advantages of a single ERP system, (where all subsidiary ledgers talk to the general ledger automatically), have long been recognized by the IT industry, which is in the process of consolidation, with Oracle and SAP the most likely survivors. The long-awaited arrival of XBRL (which is used to electronically tag data in a standard format) may also be a relevant development in technology. If the SEC provides a common chart of accounts for external reporting using XBRL, it may inspire companies to tag their ledgers, thereby achieving the dream of straight-through reporting, from ledgers directly to the SEC. In this event, XBRL could be expected to improve efficiencies around the generation of “hard” numbers.

“Soft” numbers can have a major impact on the financial statements. Witness the volatility in earnings attributable to mark-to-market accounting under FAS 157, which has helped to roil the markets. As noted, the estimates and projections that go into the “soft” numbers can be difficult to substantiate, especially if they turn out to be wrong. For all their importance, many companies generate their “soft” numbers using ad hoc procedures that remain offline and apart from the closing process. For example, marking Level 2 financial instruments to market requires the solicitation, tabulation and analysis of comparable price quotes. This exercise is often completed using spreadsheets or other unstructured media, which ultimately support a journal entry back into the ledger. The heavy reliance on spreadsheets can create an unstable environment which is difficult to duplicate, let alone automate, from one quarter to the next.

There are certain procedures that are common to the control and automation of “soft” numbers, some of which are presented below:

- Rollforwards.
- Standardized calculations.
- Account reconciliation tools.
- Web-based data gathering tools.

A typical rollforward of reserves under FAS 5 is shown below:

<b>Beg Balance</b>	<b>Payments</b>	<b>Refunds</b>	<b>Accruals</b>	<b>Transfers</b>	<b>End Balance</b>
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Much of the activity in the period (cash payments, refunds, accruals and transfers) comes from the ledgers. Storing these “hard” numbers and completing the rollforward inside of a structured database package creates an opportunity for automation, as the activity can be imported into the system directly from the ledgers. Fresh accruals based on the opinions of various legal and technical experts, often outside the company, (the “soft” numbers) must also be taken into account. These changing estimates of risk will impact the journal entries needed to adjust the balances, which will in turn drive earnings. A web-based rollforward can share this data with many professionals, allowing all FAS 5 issues to be updated concurrently. Such an approach creates a repeatable work flow that can be used across many tasks. This can lead to significant efficiencies in the workforce as workers can be cross-trained to rollforward different accounts in the same software. So, an accountant who knows how to rollforward a legal reserve within the system can also rollforward a bad debt or impairment reserve.

Standardized calculations are computations that are common to many different companies and can often be handled by an outside vendor more efficiently than the companies themselves. Standardization allows vendors to scale their solutions in ways that can create very robust applications. This relieves companies from complex spreadsheet calculations that can be difficult to maintain and often create bottlenecks in the process. For example, many companies use the treasury stock method when computing their fully diluted earnings per share. While extremely complex, the calculation is standard across many companies and industries. As such, it is a good candidate for outsourcing to a

vendor who specializes in the field and can deliver a solution more robust and less expensive than an in-house effort.

While many companies have procedures in place to reconcile the “hard” numbers generated by their ledgers, the reconciliation of “soft” numbers can be more challenging. This is due to the nature of “soft” numbers which are often composites taken from many different sources. For example, Other Comprehensive Income includes unrealized gains and losses, which are based on estimates of value. As the underlying assets and liabilities are settled, the true gain or loss must be reversed out of Other Comprehensive Income and included within net income, setting up a perpetual reconciliation exercise, which is extremely difficult to maintain on spreadsheets. Incorporating this type of reconciliation within a structured database will streamline the process and minimize errors.

During the close, many different professionals operating in various locations must work together. Web-based data gathering tools allow for collaborative efforts to take place in real time. New tools, recently brought to market, support the creation of spreadsheets whose results can be mapped to a structured database. For example, the disclosure around executive compensation may touch many different departments. Salary figures can be imported from the payroll system, human resources can provide the fringe benefits and an executive assist might estimate use of the company jet. All of this information can be collected on a website and then mapped to the appropriate place within a structured database where it can be controlled and rolled forward.

All of the tools discussed above are available as vendor-hosted applications. The use of such hosted applications significantly reduces the involvement and expense of internal IT departments, which can also free up the user. Since the vendor maintains and updates the software for all clients from a single environment, maintenance costs are significantly reduced.

## SUMMARY

The fast close can be achieved using the right combination of procedures and technology. Procedures need to be designed differently for “hard” numbers generated by structured systems such as ledgers, and “soft” numbers generated by the judgment of professionals. A systematic approach to recurring tasks, such as rollforwards and standardized calculations can improve efficiencies. New technologies, particularly those hosted by vendors, can provide inexpensive opportunities for collaboration and data gathering. These technologies provide many of the efficiencies needed by companies faced with increasing reporting requirements and static (or declining) growth in staff.

### **About the Author**

Kevin Brady is the CEO and Founder of ARMtech. He is the lead director of Annaly (NLY), currently traded on the New York Stock Exchange with a market capitalization of \$ 10 billion, and has served as the chair of the audit committee for 12 years. Previously, Kevin was the CEO and founder of TaxStream, which was sold to Thomson Reuters in 2008. He can be reached at (201) 238-2900 x 0237 or [kbrady@armtechnology.com](mailto:kbrady@armtechnology.com).

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