

The “Business Case” For Change

Making A Case For Automation In Financial Reporting

by

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Executive Summary:

The financial reporting process is the very last bastion within the organization to reap the benefits of process automation and reengineering. The process has not typically employed a large number of people and thus has not been viewed as a major opportunity for cost reduction or automation. Financial reporting is becoming more and more of a regulatory focus, however, and any errors made are highly visible to external bodies.

Many companies are coming out of the current recession with the view that adding more people and hours is not the option and are looking for solutions that utilize existing resources, outsourcing, and technology to bring much-needed agility to the financial reporting process. Most companies are employing a portfolio of solutions such as outsourcing specific components – such as XBRL compliance – while simultaneously looking for the right people and technology to streamline the filing process.

Key Findings:

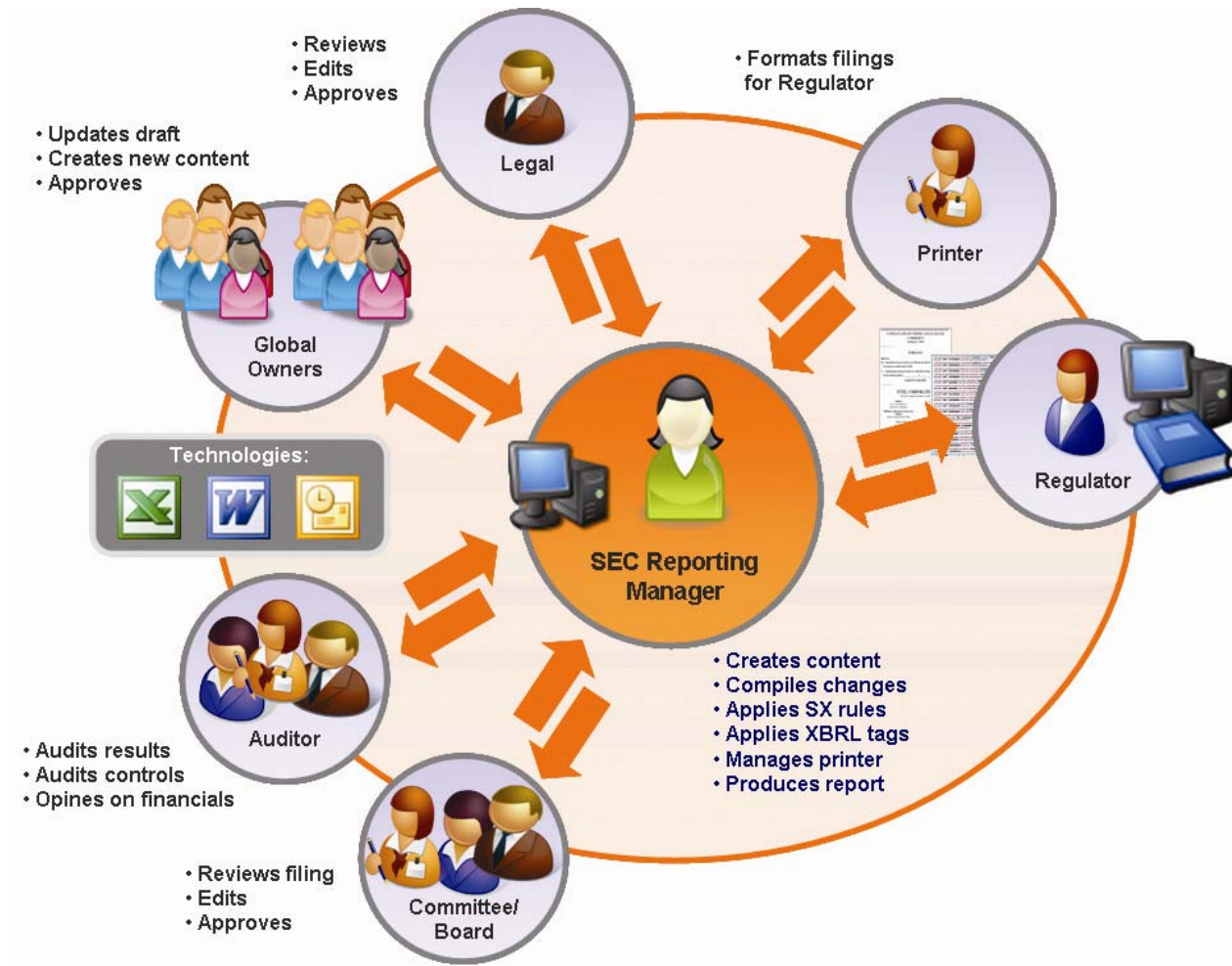
- The financial reporting process is manual, people-dependent, unforgiving – and highly error-prone. Mistakes are highly visible and come at great cost to the organization.
- There are three primary drivers of change to the current financial reporting process: continued globalization, increasing regulation, and XBRL.
- If there is one certainty in financial reporting, it is that regulations are increasingly stringent and in a constant state of flux. Compliance is becoming more difficult to achieve.

Recommendations:

- Taking a “production line” view of the financial reporting process can help automate discrete functions for repeatable, measurable cost savings over time.
- Appoint a team to analyze the issues surrounding external financial reporting and educate the business on how to achieve it.
- Create a forward-looking “business case for change” and estimate the ROI expected from any solutions being considered.
- Gradually embrace process improvement and ongoing education into the culture of your business.

Introduction

External financial reporting is a critical and important process in any public company. It involves preparing financial results in compliance with standards established by regulatory bodies, and most often associated in the United States with the Securities and Exchange Commission (SEC), the HMRC and Companies House in the UK, and the Standard Business Reporting initiative in Australia, among others. The process is generally managed by a relatively small group of specialized accountants who are experts in the requirements of the various agencies. Regulations are very specific around both the content and form for filings. The reporting team is generally led by someone with the title of SEC or Reporting Manager. These reporting teams interact with a wide variety of constituents to produce the final results: the controller’s office, business units, internal legal, external legal, tax, the auditors, management, and the board. The filing timelines are stringent and precision is required.



In most companies, this critical process is burdened by the following issues:

Manual Processes

The reporting process is the very last bastion within the organization to reap the benefits of process automation and reengineering. The process has not typically employed a large number of people and thus has not been viewed as a major opportunity for cost reduction or automation.

Financial reporting is becoming more and more of a regulatory focus, however, and any errors made are highly visible to external bodies.

The work is managed manually and with desktop office tools which can create inefficiencies in data gathering, change management, and document versioning. In many situations, the lack of an audit trail can increase the length and cost of audits, and open the business up to non-compliance penalties. Obtaining the data required for many areas – such as operating statistics (for the management discussion) or obligations (for the commitments footnote) can be onerous. The instructions may be unclear, data is often highly distributed throughout the business, turnover can create time lags, and differing priorities can cause lack of responsiveness. SEC Reporting Managers report many staff hours spent each quarter attempting to contact a long list of global players to obtain the needed information for commitments or leases ... only to discover that the right person is no longer there or the information received is not what was needed. And each period the process repeats itself, the lack of an efficient “roll-forward” capability requiring key stakeholders to start over from scratch.

People Dependent

The SEC Reporting Manager and team are the hub of the process: the bulk of the work is dependent on them to create content, filter and distribute all documents for review, then keep track of multiple, last-minute changes before obtaining final approvals.

An almost crippling lack of standards, technologies and documentation in the often frantic reporting process can be a real financial and operational burden and risk for a company, especially if the SEC Reporting Manager becomes ill or departs.

The author of this paper spoke with an accounting manager who lost a key player mid-quarter and discovered that despite adequate Sarbanes-Oxley (SOX) documentation, which detailed the general reporting process, there was no specific documentation specifying who prepared certain key data, and how key information was distributed.

Unforgiving

There is very little room for error. SEC teams can describe in great detail the hours of time spent cross referencing and checking details in the filings to ensure internal consistency and correct rounding have occurred. The data coming from a variety of sources is rarely in number format consistent with the filing requirements. The work of checking and rechecking it is tedious and subject to human error.

The “Groundhog Day” effect comes into play, as verifying and cross checking are repeated multiple times as final changes are occurring. The deadlines are tight, the hours late, and the effort to ensure absolute precision is too often a manual one.

Changing Regulations

The rules are in a constant state of flux. A company is dependent upon its experts in reporting to keep the business up to speed on the changing requirements in reporting. These changes range from the type of forms required, to detailed changes in required

disclosures. Understanding the changes may require outside consultation with legal counsel, training, and a mountain of reading material. SEC Reporting Managers are consistently reporting a desire to have more time to ensure they are up to date on recent developments.

Error-Prone

The cost of errors in reporting are high: embarrassment, assessed fines, Substantive Audits by Regulators and External Auditors, and a longer comment letters from the SEC are the results. Errors can be as small as using an incorrect form, all the way up to a material misstatement of financial results.

Direct costs are not the only impact – the indirect effect of increased capital costs must also be considered. In a study conducted by Financial Week it was reported that restatements typically cost a company an average of 69 additional basis points on a loan. For example, a \$100M bank loan might require an additional \$1,000,000 in interest per year. If the restatement is a result of fraud, add an additional 35 basis points on top of that. Collateral damage can include shorter loan terms, fewer lenders willing to extend credit, and more assets required to secure the loan itself.

One of the greater concerns outside of SEC enforcement is the threat of being delisted from commodity exchanges, or of having debt covenants “called” due to non-compliance. In the past several years, several companies have experienced the snowball effect resulting from not staying current with SEC filings: stock delisting to loss of key government contracts and eventually debt calls that can’t be replaced due to tight capital rates.

These issues are not new or particularly jarring, as reporting departments have been muddling through the manual filing process for countless years. But management’s insistence on shorter and more efficient cycle times, combined with three upcoming changes seem to be driving a new focus on rethinking the SEC reporting process, in an attempt to bring more agility, efficiency and transparency:

1. Continued Globalization

The continued spread of finance functions due to shared services, outsourcing and acquisitions stretches the manual reporting processes almost to the breaking point. The lack of control over timeliness and consistency of responses is driving reporting managers to seek more automated and standardized approaches.

2. Increasing Regulation

International Financial Reporting Standards will require significant education, training, and time for the SEC Reporting team in become educated and adept in the new reporting requirements. The changes anticipated from IFRS will have large impacts on the reporting team, who are

XBRL: eXtensible Business Reporting Language

XBRL, an initialism from eXtensible Business Reporting Language, is a technical standard for the description of financial and related data. XBRL provides a means to assign standard “tags” to data in financial reports and systems, such as “Net Profit,” so the values can be understood in context and analyzed through software.

The first phase of the SEC mandate for XBRL filing has already begun. Large domestic and foreign accelerated filers — primarily “Fortune 500” companies — must now submit XBRL data with their financial reports. These companies are currently required to identify approximately 300 disclosure elements through XBRL. Explanatory footnotes must also be tagged as supporting references to values.

All filing companies will be required to submit similar XBRL data beginning in 2010.

Immediately after this initial phase, the scope of XBRL tagging will increase for all companies. Within the next year, the number of required disclosure elements for the large filers increases from 300 to nearly 3,000. Tagging of all financial values, including those within explanatory footnotes, will be required. These requirements will apply to all filing companies beginning in 2011.

More significant reporting and XBRL changes are also expected as the SEC begins the transition from traditional reporting standards based on US Generally Accepted Accounting Procedures (GAAP) to International Financial Reporting Standards (IFRS) within the next five years.

attempting to bolster their knowledge in order to manage the new requirements and skills. Australia's Standard Business Reporting initiative and a standardized XBRL taxonomy in the Netherlands will need to be considered for companies with a global footprint.

3. **XBRL**

Extensible Business Reporting Language, or XBRL, warrants discussion in that it complicates not what is filed but rather how the documents are filed. This standard is in place now and rolls out over the next three years to all companies filing with the SEC.

- a. For a detailed discussion on automating XBRL compliance, see "**Tag, You're It: A Winning Strategy For Automating XBRL Compliance**" at the following URL:
<http://www.trintech.com/learn-more/white-paper-library/download-tag-you%E2%80%99re-it-a-winning-strategy-for-automating-xbri-compliance/>

Companies looking for prepare for changes in reporting are generally taking three steps: educating themselves about the upcoming regulatory mandates, developing a forward-looking business case for compliance, and gradually embracing process improvement and ongoing education into the culture of the business.

1. **Understand the Impending Regulatory Changes**

It's important to understand what's coming. Several of the major changes under review are:

- **IFRS**

There is a wealth of knowledge available on IFRS, much of it stating that companies will have their own interpretations and require expert input on how to proceed with compliance. The reporting team will need to understand how the data needed for the new requirements can be obtained from existing systems and sources and what kind of adjustments will be needed to meet those requirements. Many companies are in a holding pattern on IFRS, waiting to see what will be required in the months ahead, but most have at a minimum assessed the impacts, data requirements, and started redirecting resources to prepare.

- **Transition of EDGAR**

The SEC's replacement system for EDGAR is in a holding pattern since the 2008 discussions about a future filing service. Although EDGAR may exist in some form for a long while, the parallel process of filing in XBRL will eventually bring the mortality of EDGAR back into conversations. Some have even postulated a more real-time system where files are "updated" rather than re-filed. The skills required to prepare the filing information, as well as take advantage of competitive information, will continue to evolve as the SEC rolls out changes in the "how" part of the filing process. Leading reporting teams are following these developments closely, participating in discussion forums and obtaining the technical guidance and training they need to ensure they have team members who can translate the new, more IT-oriented filing requirements.

"We're Accountants"

Several SEC teams who have been voluntarily filing with XBRL for several years recently reported to this author that they are comfortable with the general requirements of XBRL.

But one team who have spent a significant time with XBRL, when asked if they planned on bringing the tagging in house they stated "we are accountants."

The implication is that SEC Reporting Managers may not have the appetite for the hands-on familiarity with HTML and XML which will be required for compliance.

- **Extensible Business Reporting Language (XBRL)**

XBRL data will be the standard in a few short years and companies will be legally bound to the accuracy of those filings – which will require a high level of familiarity and confidence in the information in HTML formats. For the longer term companies need to determine a path forward that is most efficient for them and enables them to (1) confidentially certify that their XBRL filings are absolutely correct and (2) have the tools, relationships and skills to efficiently make any adjustments to assure they can file timely in XBRL. In the short-term, a majority of reporting managers are currently relying on their printers to take the first pass at complying with XBRL to get through the first and second year SEC requirements described above.

2. **Create a “Business Case for Change”**

It’s important to get an idea of the people, processes and costs associated with the financial reporting function within your business. Have your team track all efforts associated with a quarterly or year-end reporting cycle in order to effectively identify current state, and make sure to identify all external auditor fees.

Once your business understands what is required, and has gauged your current state of compliance (or lack thereof), the reporting team should develop a forward-looking plan, including the supporting business case to acquire the skills, tools, and partnerships that will be required.

This will require knowledge of the time required to complete each point in your financial reporting process, and an idea from your vendor of the savings expected at each point along the way.

Being able to fully articulate the current costs of reporting – including internal costs, external costs, and technology costs – is often a more difficult task than anticipated. It may help to follow the formula below to identify potential areas of savings and prepare your business case:

- **Savings From Automation**

Employ a production mindset to the reporting process. Set benchmarks for performance and work towards a future state goal based upon realistic ROI savings over time. Automating the process surrounding the administration of financial reports can result in significant savings in man hours, especially in year two and beyond. The savings are generally not in replacement of personnel but rather in lowered consulting costs, overtime or transfer of costs to other deferred projects.

Technology can support workflow, roll forwards, updating, document distribution, cross checking, and process documentation. Create sustainable processes that can be “turnover” proofed by creating documentation in a system of record that is easily updated and has audit trails. The cost of turnover is estimated at generally between 1% to 1.25% of salary. Create processes that take people out of bottlenecks, allowing technology managed the mundane and routine tasks.

How to Calculate Your Savings From Automation:

$$\text{AutomationSavings} = (\text{CurrentManHours} \times \text{LoadedLaborRate}) - (\text{FutureManHours} \times \text{LoadedLaborRate})$$

Rules of Thumb:

- Year two and beyond, savings should be higher as education and on-boarding have now occurred
- Overtime costs should be minimized once an automated solution is in place to smooth workload spikes and reduce cycle times
 - It can be helpful to quantify expected cycle time savings in number of days for senior management
 - Make sure your solution allows multiple people to work on the same document at once, reducing cycle times and man hours both
- Expect for manual errors and the associated validation and rework to be minimized upon implementation
- As a result embedded documentation, training efforts due to turnover should be reduced significantly
- It may be helpful to roll up your savings into another metric, "Savings Per Report," for management

- **External Savings (Audit Fees)**

Outside and auditor fees should decrease post-implementation. Your financial reporting solution should allow for advanced, automated communication mechanisms between internal SEC Reporting teams and external SEC auditors or other outside accounting vendors, reducing the time required to communicate and audit fees in the process. The ideal solution also includes an ability to send digital "eBinders" which include pre- and post-close task management details for compliance documentation, greatly reducing the paper exchanges and communication gaps with the auditors.

How to Calculate Your External Savings (Audit Fees):

$$\text{AuditSavings} = (\text{CurrentAuditHours} \times \text{LoadedAuditRate}) - (\text{FutureAuditHours} \times \text{LoadedAuditRate})$$

Rules of Thumb:

- An audit trail, combined with automated workflow, checklists and communication mechanisms can reduce auditor hours by up to 25%
- High hourly rates from your auditors can mean small savings in time add up to large cost savings
- "Drill-down" capability into pre-close audit trails can significantly reduce the time and effort to research specific tasks during an audit
- Digital "eBinders" in your financial reporting solution should allow auditors to spend less time validating your processes and more time validating actual compliance

- **Non-Compliance Penalty Savings**

An effort should be made to identify the risks associated with non-compliance, and determine how effective any financial reporting solution is in reducing your exposure to these costs. Of the various penalties and processes in interfacing with the SEC, The comment letter process is one common area that can cost the company more than expected. Calculating the current costs of internal and external burn based on length of comments is often overlooked but can be estimated. Once these are calculated, tying a specific dollar amount or number of comments into your solution's dashboard reporting structure can enable senior management a forward-looking rollup of possible penalties should filing dates be missed or material misstatements arise.

It is not unusual for a corporation's stock price to decrease immediately upon informing the SEC that a financial statement will be filed late – a decrease of around 2% can typically be expected. A late filing can also have an impact upon the interest rates charged by your bank and make it more difficult to acquire new lines of credit.

For the less frequent but expensive material misstatement, it's difficult to estimate your exposure other than by keeping a close watch on those levied against your competitors and industry colleagues, and estimating your potential exposure. Multi-million dollar penalties are not uncommon, and it is a legal negotiation with the SEC how the penalties are calculated.

How to Calculate Your Non-Compliance Penalty Savings:

NonComplianceSavings = EstLateFilingPenalty + (LatestStockPrice x .02) + EstCreditMarketImpact + EstIndustryPenalty

Rules of Thumb:

- o Personal risks of non-compliance are difficult to quantify but should not be ruled out, including legal fees, loss in productivity for the executive involved, and fines in the range of \$1MM to \$5MM
- o Benchmarks, thresholds for performance, warnings and alerts within your financial reporting solution should reduce the possibility that deadlines are missed and thus late filing penalties (*EstLateFilingPenalty*)
- o A "cascading" financial reporting structure, embedded within and enforced by your solution, should reduce the possibility of material mis-statements due to error by updating calculations and tables when source data is changed (*EstIndustryPenalty*)

3. Embrace Process Optimization as a Way of Life

Change doesn't happen overnight, and there is no magic bullet that can fix the financial reporting process. Once your business case has been approved, it's critically important to embrace process optimization and compliance education into the fabric of your business. Many financial reporting solutions can be retooled to include educational task lists such as surveys and quizzes in support of such compliance and process awareness initiatives.

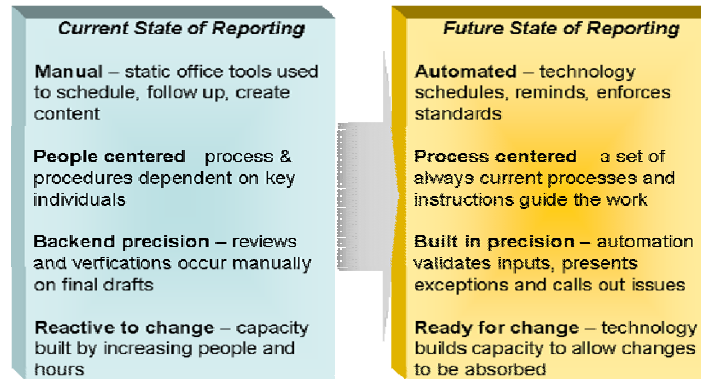
A phased approach is critical here, and strategic businesses are starting with a "test and learn" approach which allows them to tackle a portfolio of compliance projects internally, while outsourcing more complicated efforts such as XBRL until the internal bandwidth has been freed up for the SEC Reporting team to bring them in-house. When evaluating automation vendors, it's important that any solution be flexible enough to adapt to future regulatory mandates, with a platform of integrated, modular applications capable of managing different functions within the Office of Finance. A modular system architecture capable of scaling quickly is important, and key functionality will include:

- Document management tools including collaboration, redlining, "roll-forward" document templates, and version control
- User management features including scheduling, check lists, action plans, and escalation processes
- Audit trail functionality
- Support for segregation of duties and information
- Open APIs to facilitate integration with existing ERP/CPM systems
- Quantitative and qualitative testing mechanisms
- Support for the tagging and output of XBRL compliant financial statements
- Configurable management reporting features

Conclusion

The given is that regulations will continue to change. The reporting process has thus far sustained itself through a vast number of changes by applying more people and hours as

required. Many companies are coming out of this recession with the view that adding more people and hours is not the option and are looking for solutions that utilize existing resources, outsourcing, and technology to bring much-needed agility to the financial reporting process. Most companies are employing a portfolio of solutions such as outsourcing specific components – such as XBRL compliance – while simultaneously looking for the right people and technology to streamline the filing process.



Given the proliferation of regulations, taking the time to create a “business case for change” can help your business get a view of where you currently stand. A “production line” view of the financial reporting process can bolster this business case allowing you to automate discrete functions and achieve repeatable, measurable cost savings over time.