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Intervention: The financial close process

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For many broker-dealers, the financial close process is viewed as a necessary evil, associated with late nights, volumes of journal entries and ticking clocks. However, this quarterly exercise can do a world of good by providing internal financial indicators and maintaining a strong reputation with regulators and stakeholders. Before filing your 10Q, 10K or Financial and Operational Combined Uniform Single (FOCUS) report, make improvements to this process to produce higher quality results in a shorter time frame with fewer errors and headaches.

There is a lot of pressure associated with the financial close process. Management needs key performance metrics in a timely manner in order to react to market changes. Investors, analysts and ratings agencies are demanding more details in public companies' earnings press releases. Regulators are imposing tighter

deadlines and requiring increased disclosures. Hence, the financial close process must encompass a range of objectives without letting anything fall through the cracks. Your closing process can take on several forms:

- Hard close: focuses on accuracy and results in GAAP/SEC financial statements;
- Soft close: produces materially accurate financial data to be used for internal management reporting, typically only used on an interim monthly close between quarters;
- Virtual close: reflects on-demand availability of vital management reporting.

Symptoms of closing issues

How can you tell if your closing process needs improvement? Here are some signs that could point to problems with people, processes or technology:

- Excessive overtime
- Staff turnover
- Pushing or missing deadlines
- Labor-intensive manual processes

- Inconsistent reporting from subsidiaries
- Redundant data checking
- Numerous manual journal entries
- Spending too much time manipulating data, not enough analyzing
- External reporting has become management reporting

Diagnose the root of the problem

Determine the cause of the symptoms in order to find long-term solutions. Inexperienced staff, improper training, inappropriate job assignments and

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uneven allocation of responsibilities are potential culprits of people-related problems.

Obstacles also can stem from undocumented processes, non-standard charts of accounts and inadequate precision and methods for accruals. Technology inefficiencies like multiple systems with limited interfaces and difficult drilldowns into sub-ledgers can lead to problems during the financial close process.

The remedy

By conducting a thorough analysis, you can increase the timeliness, accuracy and value of the closing process and improve productivity and employee satisfaction.

Step 1: Analyze and assess

Interviews

Don't underestimate the power of asking questions. Listen to the people actually doing the work. Meet with management to unearth those issues that may not be obvious to them. Be ready to explore any grassroots efforts already underway at the staff level. Confirm key points to ensure all parties are on the same page.

Process map

Gather information from one quarter and identify key inputs, outputs and dependencies. Look at the layers, beginning with corporate headquarters, and work your way through any subsidiaries. Include footnote preparation (like FAS 157 disclosure) and address any changes in accounting methods or new pronouncements, such as the liquidity haircut charge for auction-rate securities. Also note capture of accounting data by operations personnel, i.e., suspense items and aging components of regulatory computations.

Ask staff to record their time by task, including start and end dates and total time required. If a closing target is

missed, note the reason (i.e., deliverable late, system issues, etc.). Record errors found in the analysis.

Review findings

Focus on the processes that drive completion dates, including the 17-business day requirement for FOCUS reports. What is the impact of feeder systems, processes and divisional and sub-ledger inputs? How is labor balanced? Analyze dependencies and timing. Zero in on slow processes and make a checklist of improvement opportunities.

Step 2: Report and recommend

Formulate recommendations based on the list of improvement opportunities, which may require changes in people, processes or technology.

- **People:** Identify bottlenecks and redistribute work as needed, assess quality of resources and adequacy of fit, identify training shortfalls.
- **Process:** Better define the process, establish explicit ownership, plan for clean handoffs and a well-defined workflow.
- **Technology:** Integrate records, automate workflow, balance security and data sharing, ensure efficient use of existing tools.

When reporting to senior management, present the costs and benefits of key recommendations. Identify low-hanging fruit to demonstrate quick wins. For example, a redistribution of work might save a day or two by removing a bottleneck in the process. Gain the support of the workers. Finally, introduce a plan to implement those recommendations.

Step 3: Implementation

Identify a member of senior management to serve as the executive sponsor of the improvement project.

Establish a steering committee comprised of key stakeholders and include IT from the beginning. Assign a project manager and consider using "borrowed" resources when possible. Define project reporting for accountability. Treasure what you measure — if there is no accountability, necessary changes will not be made. Set a budget and timeline, including target dates that tie into the closing calendar. This schedule should be made available across the firm's departments, complete with details such as interactions with auditors and disclosure committees.

Structure improvements by type, from system enhancement to communication gaps. Create a standard journal entry checklist to help establish ownership, flag nonstandard entries and identify manual journal entries that could be automated. Also, document closing policies and procedures. These policies are only useful if accessible and relevant — publish plans and use them for training.

Identify and report key indicators by setting baseline targets and holding managers accountable. Institute "flash" reporting to management based on the virtual close and allow daily reporting with drilldown. Flash reporting reinforces the importance of intraclose accuracy and reduces the demand for ad hoc reports from management. For example, compile an online data warehouse with automated footnotes and workflow-driven approvals.

Establishing a better financial close process can lead to better quality reports with fewer restatements and less strain on resources. As regulators and investors seek increased transparency and new standards like International Financial Reporting Standards appear on the horizon, an efficient and effective financial close process becomes even more vital to your firm's health. •

What's on the horizon for broker-dealers?

By Richard Flowers, Financial Services

Audit partner

The turmoil within the financial markets has radiated beyond the collapses and acquisitions of investment banks. Several of these brokers have chosen to become commercial banks to avoid the fallout. However, even amid recovery efforts, the more than 5,000 firms subject to the SEC's Division of Trading and Markets must still face their own operational and accounting issues in the coming months.

FAS 157: Fair value

As the SEC continues to focus on the accuracy of valuations, broker-dealers must be attuned to the requirements of FAS 157, *Fair Value Measurements*.

FAS 157 establishes a three-level fair value hierarchy that prioritizes the inputs (or assumptions) for assets and liabilities.

- Level 1 securities are those that have identical securities traded on an active market, i.e., exchange-traded securities.
- Level 2 inputs are observable either directly or indirectly, i.e., debt securities traded on an active market with matrix pricing.
- Level 3 inputs are unobservable, i.e., management assumptions.

One area to consider under FAS 157 is that broker-dealers often receive placement fees in the form of securities that may not be classified as Level 1 or 2 and therefore may be included in the Level 3 classification.

Although FAS 157 has resolved many of the inconsistencies of fair value, broker-dealers must be cautious when assessing the significance of a particular input to the fair value measurement in its entirety. Broker-dealers have to consider valuation methodologies, which consider exit price in the appropriate market for these securities.

Repurchase financing transactions application

Many broker-dealers will be implementing Financial Accounting Standards Board (FASB) Staff Position 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, for the first time. Under this guidance, repurchase financing is defined as a transaction in which the buyer (initial transferee) of a financial asset obtains financing from the seller (initial transferor) and transfers the financial asset back to the seller as collateral until the financing is repaid.

This typically may occur when a hedge fund acquires securities from a broker-dealer for a relatively short period and agrees to return the securities (generally over a financial reporting period). Although the security had been considered a sale under FAS 140, such a transaction is reversed now and restored on the broker-dealer's books with a separate recognition of the value of the forward obligation to buy back the security.

This guidance is effective for fiscal years beginning after Nov. 15, 2008, and interim periods within those years. The challenge for broker-dealers is identifying those types of repurchase financings and gathering the appropriate reporting data.

Off-exchange transactions

Off-exchange transactions pose a heightened risk for the securities industry. With foreign exchange-traded products, credit default swaps, total return swaps and other privately negotiated transactions, it is more difficult to affirm transaction details, margin requirements, settlement instructions and payment.

For swaps, broker-dealers should ensure that they have a ready measure of the unaffirmed transactions and appropriate collateral to cover exposure with respect to credit default and total return swaps. Valuation of the collateral and whether it's held in a good control location should be assessed. Build a thorough understanding of the cross-margining agreements to avoid potentially costly misunderstandings.

The National Futures Association requires a controls review of foreign-exchange broker-dealers to be conducted by an independent public accountant registered under Section 102 of the Sarbanes-Oxley Act. The report must include:

- a detailed explanation of the accountant's examination;
- a representation that the accountant has examined and tested the foreign-exchange dealer member's system of internal controls, providing assurance that the reporting and preparation of financial statements are in accordance with GAAP; and
- the report must state that no material weaknesses were found.

IFRS

International Financial Reporting Standards (IFRS) represent a sea change for the entire industry. Broker-dealers

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What's on the horizon for broker-dealers (continued)

should be aware of developments and prepare for the necessary education to integrate these rules if universally accepted.

Broker-dealers should be especially attuned to accounting principles (recently modified for GAAP) that would be treated differently under IFRS, including

valuation at exit price, day one gain recognition and business combination principles.

For further guidance about how to navigate these items and new developments, contact Cynthia Keveney, Grant Thornton LLP's Financial Services marketing director, at 212.624.5495. •

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For additional information on the issues discussed in this newsletter, contact Cynthia Keveney, Financial Services marketing director, at 212.624.5495.

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