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Ten Sure Signs Your Finance Department Is Second-Rate

Our first installment of a new monthly feature -- Ten Sure Signs -- examines what might be considered ''not the best'' practices. They can make themselves felt not only in your finance department, but also in your company as a whole -- and in your career.

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December 01, 2002

You can't benchmark the performance of one finance department against another, says Blythe McGarvie, CFO of the Paris and New York-based BIC Group. The same numbers, she argues, are handled by different companies in too many differently nuanced ways for direct comparisons to be practical. Many finance chiefs, consultants, and academics *are* willing to make those comparisons — but they disagree on where to draw the lines.

McGarvie and the others we interviewed for this article, however, all agree on several indications that do provide a certain measure of a finance department. (Within this article, "finance department" refers to all those areas over which the CFO holds sway.)

Steer clear of these treacherous areas, and you have no guarantee of success; run afoul of them, on the other hand, and your finance department simply cannot be considered among the best. Your company and your career may fare poorly as well.

1. Slow Closes

A properly skilled staff should produce a complete financial statement within ten days of the quarter's end, says Miles Stover of Crossroads LLC in Irvine, California. Seven days, he adds, should be long enough to produce a preliminary "flash" report suitable for internal distribution.

Stover, who's been an interim CFO on behalf of Crossroads at multibillion-dollar conglomerates and at tiny private concerns, grants an exception for companies with annual revenues under $50 million — but even for these companies, he maintains, the quicker the better.

Dave Peralta, CFO of software provider Arbortext in Ann Arbor, Michigan, doesn't hold to such a strict rule of thumb, but he agrees that "the longer it takes to close, the more inefficient the department becomes." Tasks tend to expand to fill the available time unless the finance chief has the discipline to fix a date, then push the department to meet it.

Efficiency aside, why else should you concern yourself about a leisurely close? It can be a sign that policies may need some tweaking — say, because closings are held up by laggard invoices that trickle in on the last day of the month. There's a simple remedy for that one: Move up the deadline to earlier in the month to give your staff some breathing room.

Sometimes, of course, appropriate policies and procedures are in place, but they're being ignored by employees outside your department. "That's when the CFO needs to put in some calls to get things back on track," offers Peralta. (For more on the efforts of CFOs to close the books more quickly, see "Virtual Close: Not So Fast.")

Now there's *slow,* and there's *very slow* — it's not simply a process problem when the close is a full quarter behind. Witness power producer Mirant, which filed its 10-Q for the period ending June 30 on November 7, and pharmaceutical giant Bristol-Myers Squibb, which plans to file its third-quarter 10-Q in February 2003.

"If this was just a process problem," says James Owers, a finance professor at the J. Mack College of

Business at Georgia State, management might have felt compelled "to bring in a new cast of characters in the CFO function." Owers notes that these tardy filings indicate wider problems — restatements coupled with investigations by federal regulators, in the cases of Mirant and Bristol-Myers Squibb.

2. High Audit Fees

Insiders and outsiders have different opinions about whether high fees spell trouble for the finance department. Kris Onken, CFO of Logitech International, a manufacturer of personal digital devices based in Fremont, California, maintains that rising audit fees are often an indication that a company's business is becoming increasingly complex. At a previous employer, she saw audit fees jump 25 percent while the company worked through growing pains.

Daniel Weinfurter, president of Parson Consulting in Chicago, counters that high fees, including those for non-audit services, can be traced to an underperforming finance department that requires an abnormal amount of "cleanup." Weinfurter, whose Chicago-based firm specializes in ferreting out corporate finance problems, warns executives to keep tabs on the fix-it bills for such things as slow shipments, bloated inventory, out-of-control receivables, and big write-offs for items that should have been handled earlier in the reporting cycle.

Paying a CPA $500 per hour to correct general-ledger mistakes is throwing money away, adds Miles Stover. Accounting errors should be corrected in-house by a staffer who makes $60 per hour. (Another option, many firms have found, is to have their outside audits performed by one of the many "Second-Tier Audit Firms.")

3. High DSO

Days sales outstanding (DSO) — the average time taken by a company to collect payment from its customers — can be calculated using figures from the 10-Qs or 10-Ks of a public company. When DSO rises, it also appears on the radar screens of company shareholders.

Daniel Weinfurter says an increase in DSO usually stems from a lapse in the accounts receivable process. Collection calls, for example, might not begin until 30 days after the past-due date. A related headache manifests itself as high customer adjustments, which can lead to higher DSO as well as hinder the usefulness of forecasts.

Although the CFOs we spoke with consider such adjustments to be "business as usual," all agree that when the number of adjustments creeps up month after month, something's amiss. Perhaps it's simply a warning of sloppy quality control on the assembly line, but faulty control procedures in the finance department are more common and more directly controllable.

There's no rule of thumb for DSO, mainly because industries vary greatly in the speed with which they collect. Tracking your receivables aging pattern is one useful yardstick; even better would be to compare your company's DSO with that of its peers. (To keep tabs on DSO and many other metrics, most publicly traded U.S. companies can compare themselves with their peers by entering company tickers in the CFO PeerMetrix interactive scorecards.)

4. Multiple Payments

Are your vendors seeing double? When they bill you once and you pay them twice, you may ensure that your company's credit is stellar, but it's not great for cash flow. Kris Onken remembers when, as a newly hired controller for a previous employer, three different vendors notified her of double payments. "I can only imagine how many more were out there that never reported it," she laments.

Your accounts-payable system is probably not to blame. Most standard accounts-payable software incorporates a safeguard that matches up each check with an invoice. Even off-the-shelf small-business software that retails for under $100 usually has that invoice-matching feature.

"Double payments, or slow payments, often have their origins in operations," observes Dave Peralta, and to some degree the finance department must rely on the diligence and discipline of the operating units.

Bill Hurley, practice director at Parson Consulting, notes that new, sophisticated procurement systems have added another layer of complexity to the payment process. True, these trading systems may standardize the information gathered from vendors — but if an accounts payable employee runs into a snag while negotiating four or five software filters, an exception can take weeks to resolve.

Whether double-payment problems begin with poor compliance by operating units or with haywire procurement systems, the buck stops with the finance department. (That's a big reason so many companies are "Working on the Chain.")

5. Earnings Restatements

According to the U.S. General Accounting Office, during the past five years 10 percent of all publicly traded companies restated their earnings because of accounting irregularities. About 250 companies, the GAO estimates, will restate by the end of this year, far more than the 92 companies that restated in 1997.

Most restatements aren't a harbinger of fraud, simply the result of common accounting errors or oversight. **Parson's Weinfurter** maintains, in fact, that two-thirds of all restatements are caused by trip-ups related to revenue recognition. A restatement usually won't bring a company to its knees, adds Logitech's Onken, but "it's still a black eye." (Or is it a knockout punch? In a poll conducted for our special report "CFOs: The New Patsies?," more than 60 percent of respondents thought that an earnings restatement was the biggest threat to a CFO's career.)

Many errors that might lead to a restatement are caught by internal audits and corrected. When they slip by, says Professor Owers, it's a strong signal that the accounting and financial functions are having a problem with accounting judgments.

6. Manual Entries

The sole proprietor of John's Coffee Shop can automate his books for $80 with an off-the-shelf software package. Not only will he free himself from manual entries, his accountant tells him that he'll be able to shore up his financial controls.

For larger companies, however, ridding the finance department of manual entries and stand-alone spreadsheets is proving to be a Herculean task (think "Aegean stables").

Parson's Hurley says that 99 percent of his clients — these are Fortune 500 firms, mind you — still work with spreadsheets or disparate financial systems. Only the Fortune 50, claims Hurley, are really breaking away from their reliance on spreadsheets, since only these companies have the resources to connect far-flung systems with middleware and to wean employees from spreadsheets by retraining them.

Spreadsheets are still handy for running "what if" scenarios as well as budgeting and forecasting exercises. But when the subject is financial controls, notes Crossroads' Stover, relying on stand-alone spreadsheets instead of financial systems "violates the audit trail." More opportunities exist for mistakes — or wrongdoing — and widespread use of spreadsheets means that a company's financial-database history is useless.

Balance sheets and income statements, Stover maintains, should be posted within a systems environment. (For more, see "Core Values," our ERP buyer's guide.)

7. Lack of Transparency

Accounting is a straightforward science, says Arbortext's Peralta, and transparency is a non-negotiable item for both internal and external reporting.

From an internal perspective, the department must respond to questions with timely and logical answers. When the mechanisms that deliver reports are too confusing, or when the systems that should be running routine reports are spitting out incorrect or incomplete information, that inefficiency should raise a red flag.

Deal with it promptly: While poor report generation creates an unproductive finance department, it also hamstrings business units that depend on updated financial data. When operating units don't get the information they need to support their management and planning decisions, they're not likely to keep quiet.

As for external reporting, Professor Owers gives straightforward advice: Meet disclosure requirements and do it quickly. He praises broadband services and products purveyor Scientific Atlantic for management's quick announcement about the financial impact of the bankruptcy filing of Adelphia Communications, a 20-year customer of Scientific Atlantic. Footnotes, Owers counsels, should follow the spirit and not just the letter of the law. (Easily said — but faced with tough new reporting requirements, many CFOs are having difficulties with "The Fear of All Sums.")

8. Dubious Structures

First, and most dubious: If your internal audit team reports to the CFO, you would be hard-pressed to find an executive, regulator, or Sunday-morning talk-show pundit who did not bristle at the potential conflict of interest.

Every CFO we interviewed for this article insists that this line of report is a grievous governance deficiency that's wide open for exploitation. (The flip side, as exposed by our article "There's a Monster in Finance, is that the newfound power and independence of internal auditors poses its own threat for finance chiefs.)

Then there's the case of the company whose treasurer and controller each reported their own cash number — different numbers, that is. (Apparently the discrepancy stemmed from an inflated cash sum reported by the treasurer, who ignored the float on the cash balance.)

It turns out, says Michael Feder, a partner in the Chicago office of turnaround firm AlixPartners, that the two executives were aggressively competing for face time with the CEO and CFO. A little competition is fine, but it should never trump a clear delineation of duties.

Another crack in the structural foundation is improper division of duties. For example, internal audit rules usually require that the employee that receives checks doesn't post them, and that the employee who prepares checks doesn't sign them.

Finance chiefs agree that its often impossible for very small companies to separate the administration of payables, receivables, and bank-statement reconciliation among three different people. For companies of more than 100 employees, however, it should be mandatory.

9. Too Much Coziness with Sales

At its root, this is a problem of revenue recognition, and of training the sales department about just how serious an issue this can be. Just last week, Computer Associates landed back in the headlines over new allegations that it had shifted revenue from quarter to quarter, a practice that could violate generally accepted accounting principles (GAAP).

Accountants from Logitech International, declares CFO Kris Onken, are routinely sent out into the field "to put the fear of God into the sales staff." ("Routinely" used to mean about twice a year, but since Sarbanes-Oxley it's been four times in four months.) Onken insists that the finance department is responsible for educating the salesforce about when to book revenue — "but there can be no doubt who is boss."

What's on the syllabus? It's a refresher course in revenue recognition rules, for new and existing employees, including "what if" scenarios and a question-and-answer period. In addition to the sales and marketing staffs, Onken's team trains other supply-chain workers such as order-entry and shipping employees.

Sales employees should understand the nuances of different contracts, and other supply-chain workers should have at least some familiarity with them. For example, one Logitech agreement states that the company will ship products to a customer warehouse, but the inventory title is not transferred until the customer actually pulls products from the warehouse — so revenue cannot be recognized until that time.

In a good organization, say many CFOs, the sales and marketing departments should be aggressive about order flow, and the accounting department should lend a helping hand when it can do so appropriately. But when "lending a hand" leads to postponing sales problems — or even straying from GAAP — a company might pass "second-rate" and drop to the bottom of the barrel. (For more, see RevenueRecognition.com.)

10. High Staff Turnover

Where there's churn, there's trouble, says Stover, and it's usually associated with burnout or poor management. Accountants are precise by nature, adds Onken, and the CFO has to cater to that part of their personality.

Procedures that aren't sharply defined, processes with too much wiggle room, moving targets for deadlines, inadequate staffing, systems that don't support job functions — all are incentives for employees to walk.

Some CFOs believe that substandard transaction systems are the most common cause of dissatisfaction in the finance department. Accountants detest the idea of manually extracting numbers from a system that should deliver them automatically.

Bill Hurley looks instead to procedural breakdowns as a major cause of discontent. The practice leader for **Parson Consulting** points a finger at departments that wait until the last day of the month to run the numbers, instead of updating receivables, payables, inventory, and cost of goods sold on a daily or weekly basis.

No one likes to "do the big cleanup" — especially when it's the one thing that seems to arrive on schedule, month after month. (For more on best practices and motivating employees, see "What Works: Building a Strong Finance Team.")

The best reason to keep staff turnover low might be to help communication flow more freely within the finance department. When your finance professionals and other staffers are unhappy or untrusting, word of potential problems may not reach your ears until it's too late.