Event To Knowledge – a New Metric for Finance Department Efficiency

Abstract

This article introduces the concept of Event To Knowledge or E2K. E2K is a metric that measures how long it takes an organization to record and report an event to an information consumer. E2K is an integral part of viewing the Finance function of an organization as a Value Chain onto itself. A fictional organization is presented with a maximum E2K measure of 43 days. A number of strategies are presented that reduce the organization's E2K measure down to less than 43 hours. This dramatic reduction is accomplished through improved systems, Just In Time Accounting practices, Virtual or 24 hour Accounting Cycle Closes and continuous education of the end information consumer.

Author's Biography

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Acme-Close Inc. Event To Knowledge Cycle

How fast can your Finance Department close the books and get financial information to your organization's decision makers? More importantly, how long does it take for your managers to review the financial reports and then act on the information provided? Try comparing your Finance Department to the following fictional organization, Acme-Close Inc.:

Event to Knowledge Cycle of Acme-Close Inc.	
Fiscal Month Activity	**Total Days**
30 day Calendar Month	30
Month End Close	5
Produce Financial Reports	4
Distribute hard copy reports	2
Reader Wait Time	1
Review Time and action is taken on a variance or anomaly	1
Total	43 Days

While Acme-Close Inc. is fictional, the estimated times are not. 5 days to close a financial period and 4 days to produce financial reports are averages from the Hackett Group[1]. Distributing hardcopy reports is the time to print, sort, package, and deliver the reports to a multi-site organization. The reader wait time is the time that it takes a line managers or executive to 'get around to' reviewing the financial reports.

Finally there is the actual review time. The one-day a manager spends reviewing the financial statements, and this could very well be an exaggeration. After all, the information he or she is reading is as much as 43 days old; how relevant can it be to today's priorities and issues?

[1] Gattenio, Christine A."How to Benchmark the Performance of your Finance Function." CMA Magazine April 1996: p. 23.

E2K and Your Finance Department's Value Chain

Of course not all of the information the manager is reviewing is 43 days old, some of the information occurred as recently as 13 days prior. While on average, the information occurred 28 days old.

43, 28 and 13 days represent the various Event To Knowledge (E2K) time frames for this Acme-Close Inc. 43 days is the maximum E2K while 28 and 13 are the Average and Minimum E2K's.

E2K is a deceptively simple measure that has important ramifications for Finance Departments. It goes beyond many traditional Finance Department Metrics by focusing on the point of which Finance adds value to the organization. Think of E2K as measuring the length of Finance's Value Chain. For many managers, the only value they see the Finance Department adding to the organization are the month end reports they receive. By reducing E2K time, finance can deliver value to its internal managers sooner and give the managers more time to act upon the knowledge gained from that value.

While many Finance Departments have shaved days from their Maximum E2K through more efficient month end closes and on-line reporting, leading edge companies, such as Cisco Systems, have shaved weeks off of their Maximum E2K. Through the adoption of continuous improvement techniques, new technology and re-thinking tradition Finance processes, your organization can potentially reduce your Maximum E2K time from 43 days to less than 43 hours.

The Information Consumer

The first step in rethinking the Finance Department Value Chain is identifying the end consumer of the department's product. As every Accountant knows, there are many and varied audiences for Financial information.

In general, there are two internal Information Consumers within an organization, those individuals either in a management or a transactional position. Managers are typically responsible for variances to a budget and/or overall financial results. Transactional audiences are interested in the detailed activity within the organization, for example clerical staff reconciling accounts.

In either case, both of these audiences require timely, accurate and complete financial and non-financial information from the Finance Department. These internal Information Consumers are the focus of this article.

Rethinking Your Finance Department's Value Chain

Month End Close

In the mid-1990's, the Just In Time (JIT) management philosophy moved from the manufacturing floor to the Finance Department. Thus, Just in Time Accounting (JITA) and One Day Reporting were born. JITA's goal was to reduce the total close cycle from days or weeks down to a single business day. This dramatic reduction in time was accomplished by compromising detailed, precise and highly accurate information for more summarized and materially accurate financial information. Some short cuts for JITA included the following:

Short Cut	Examples
Increasing the materiality of adjustments	Raise the capitalization threshold or increase the materiality threshold for accruals.
Pre-calculate month end adjustments	Calculate depreciation in the last week of the month rather than after the month end close.
Increase the frequency of sub-ledger postings to the General Ledger	If the financial system allows for it, post more frequently and use the finance staff to review and correct unusual entries or variances – before the month end close.
Question the value of all financial business processes.	Carefully review the value of allocations, distributions and transfer pricing schemes. Obviously this last point has larger organizational impacts beyond the Finance Department.

JITA has been given a boost in the past five years by the improved integration and sophistication of ERP systems. One of the causes of a long accounting cycle was the wait for sub-ledgers to close, extracting and balancing the information and then posting it into the General Ledger. Integrated financial systems reduce the non-value added reconciliation activities between sub-ledgers and the General Ledger.

Financial Reports

JITA also recommended the use of 'Flash Reports'. These reports are a 'quick approximate results to indicate if performance was in line with expectation with a more detailed confirmation of the result to follow in due course[2]'. In introducing Flash Reports to an organization, education is key. Managers must fully understand that the margin of error for these reports is higher than in the traditional Financial Reports that would follow.

A strong selling point for introducing Flash Reports is the value of parallel processing. If a manager identifies a significant accounting error in his or her reports, the error can often be fixed before the final month end reports are produced. This in turn reduces the need for adjustments in the following month and generally improves the quality of financial information.

Distribution of Financial Reports

Up until the mid-1990's, paper was the preferred medium for communicating organizational results. Paper was cheap, permanent and relatively easy to distribute with an appropriate infrastructure.

Paper is becoming harder to justify as the preferred medium for internal financial audiences. In a healthcare organization that I know of, 6 clerks would spend the better part of a day in a small room packaging the financial reports for about 500 information consumers. These reports would be sent through the internal mail and would then arrive on the manager's desk in another day or two. Many of these financial reports would then be stacked in the corners of offices, still wrapped in their original inter-office envelopes. It was a tragic waste of human effort and energy.

In our fictional organization – Acme-Close Inc., digital distribution of financial information will eliminate the entire 2-day Report Distribution activity, thus reducing the Maximum E2K time frame by the same amount. By using a corporate intra-net, electronic versions of paper reports can be distributed to end-users within minutes of their creation.

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[2] Petty, John; Ng, Stephen. "Towards One-Day Reporting: redirecting monthly management reporting". Australian CPA July 1999 pp. 72-77.

Wait and Review Time of Financial Reports

An email announcing the availability of the electronic reports reduces the wait time for managers. Unfortunately simply converting paper reports into an electronic version misses the true value of the digital environment.

Consider this perspective. Until a knowledgeable user has looked at and acted upon the information available in a financial report, the entire effort and process of producing that report has been non-value added to the organization.

The above perspective leads to another question, why not simply produce only the portions of a financial report that will be used? If an information consumer only wants to see a single transaction, why produce an entire Accounts Payable transaction detail? The answer of course is that using the paper medium, the Finance Department had no way of knowing which portions of their financial reports would be used by the many varied users within the organization. As a result, organizations would either send out massive detail reports or would send out summary information and then ask the information consumer to contact the department if they required more detailed information.

Digital distribution of reports allows finance departments to produce information on demand. One method of doing this is by allowing each information consumer to create and update a capstone report. The capstone report provides specific summary information individually tailored to the consumer. Thus, if the capstone report reveals all activities are within normal parameters, a manager's financial review is potentially complete within minutes. Variances or oddities are investigated by progressively drilling down into problem areas.

With the application of technology, wait time can be reduced and the information consumer can use the information more efficiently. Both of these improvements will further reduce the organization's maximum E2K cycle.

Informating Instead of Reporting

The adoption of digital report distribution allows organizations to migrate from a reporting to an informating mentality. Informating is the process of empowering users of financial information to make critical decisions without the need for hierarchical intervention. While Informating in of itself has limited impact on an organization's E2K times, it can have a dramatic impact on an organization's effectiveness and efficiency.

Calendar Month

No matter how efficient an organization's reporting or informating processes are, the most dramatic reduction of E2K time can be achieved by matching an organization's fiscal period to its natural business cycles. Returning to the healthcare organization introduced earlier, one of the largest costs of this organization was labour. All employees were paid on a bi-weekly pay cycle even though the financial period remained the calendar month. As a result, the organization needed to calculate, reconcile and the reverse payroll accruals every month.

A fourteen-day fiscal period would have made more sense for this organization. That is, instead of closing its books once a month or 12 times a year, the organization should have closed its books 26 times a year, at the end of each pay run.

Changing the accounting calendar is not a change to be made lightly. There is the added cost of closing the books more frequently than 12 times a year, the loss of industry standardization or the influence of regulatory reporting on the organization. On the first difficulty, the cost of closing more frequently can be mitigated by adopting JITA practices and by moving toward a more integrated and efficient Enterprise Resource Planning (ERP) system. The loss of industry standardization or the need to adhere to an externally imposed accounting calendar can be mitigated by either adopting accruals for external audiences or by having multiple closes.

For example, if your organization has quarterly reporting requirements, than it likely is already performing a number of accruals and adjustments to meet these requirements. Rather than imposing these external reporting obligations on internal managers, adopt a non-standard calendar that allows these managers to focus on operational issues. As a result, the burden for making required external adjustments then moves to the finance department. Part of this burden may include having a soft close for a quarterly reporting obligation.

Of course one way to avoid accruals is to close your books every 24 hours. Cisco Systems has recently achieved this break through and is able to provide its managers financial results from the prior day by 2pm. The 24-hour or Virtual close is accomplished by having business transactions post continuously.

Knowledge – Making Better Information Consumers

The work described above will deliver better financial results sooner and more efficiently to an organization's internal information consumer. This work will not deliver knowledge to the end consumer however. This is the other challenge for Financial Departments; to ensure that its information consumers understand and know how to act upon the financial results presented to them. Central to this challenge is the need for consumer education and information tool development.

Education is particularly important in organizations where the information consumers may not have been exposed to finance concepts in their post secondary education. For example, in one healthcare organization, a basic 'Finance for Dummies' course dramatically improved the confidence level of the managers taking part. Courses like this can decrease an organization's total E2K cycle.

Time – The Ultimate Non-Renewable Resource

Getting information to the end consumer quicker, and having the consumer understand this information faster conserves one of the organization's most valuable resources – time. This time can be reallocated to more productive activities. For the finance department, these activities could include the more value added activities of coaching, advising and assisting the organization to be more competitive and effective.

Although empirical evidence does not yet exists to prove this, it is reasonable to expect that for each marginal decline in the E2K time frame, there is a corresponding increase in the efficiency and effectiveness of the organization. In time, experience and research will determine what the marginal change is and at what point the organization receives diminishing returns for its E2K effort.

Putting it All Together

Measuring the marginal benefit of a 43-hour versus 43 day E2K timeframe may soon be mute however. 'Cisco CEO John Chambers predicts the virtual close will be a competitive imperative by 2010'[3]. To stay competitive, how can Acme-Close Inc, our fictional organization, make such a dramatic improvement in its Financial processes? The following 6 steps provide a guide for all organizations wanting to reduce their Maximum E2K time frame.

1. Benchmark current practices

   Measure your current Maximum and Average Event To Knowledge time periods. Pay particular attention on the Reader Wait Time and Review Time. Remember that internal financial information only becomes value added when a knowledgeable information consumer reviews the information and then acts on it.

   By acting on it, the organization's financial results are transformed from information to knowledge; thus the E2K cycle is complete. Deciding to do nothing is a valid action on the part of the information consumer.

2. Move Toward Just In Time Accounting

   What processes and steps in your accounting cycle can be eliminated, realigned or redefined without impacting the quality of the Financial Information? The use of quality circles, customer involvement (internal information consumers) and Just In Time techniques (such as celebrating every success and statistical methods) are critical to successfully implementing Just In Time Accounting.

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[3] Roth, Richard T. "Capitalize on the Virtual Close." Financial Executive January 2000 v16 i1: 45.

3. Invest in Systems

   Just In Time Accounting and the Virtual Close are dependent upon integrated and efficient information systems. This step is the most costly, time consuming and important in reducing E2K cycle times.

4. Abandon Reporting and Adopt Informating

   Internal Financial Reporting is largely a non-value-added activity. Moving to an Informating model focuses on the most value added portions of this Finance activity. Empowering the consumers of the information to act moves Financial information from a retrospective correction model to prospective prevention method of doing business.

5. Adjust your Accounting Cycle to Match your Natural Business Cycle

   This change requires careful consideration and planning to minimize the negative impact on your organization; it will also yield the greatest reduction on E2K cycle time. While a 24-hour Virtual Close is the current gold standard for an Accounting Cycle, adopting a bi-weekly or a weekly close can yield enormous benefits for an organization as well.

6. Hone the E2K Measurements and Results

   Initial E2K measurements may focus on the transactional aspects of the accounting cycle. Subsequent measures should focus on how efficiently and effectively financial information is transformed into knowledge.

What About External Audiences?

This article has exclusively focused on the internal Information Consumer because they have the greatest stake and ability to act on financial information. If the fictional managers of Acme-Close Inc., or your organization, are able to make better-informed decisions faster and see the results of these changes quicker as well; then the organization as a whole is better off for it.

This in turn benefits the external stakeholders, such as investors, creditors or governments. Thus while E2K, JITA or the Virtual Close will not change the format or perhaps even the timing of externally reported information; E2K will improve the quality of the information and performance of the underlying organization.

Conclusion

Reducing the E2K timeframe has two parts, improved transaction processing and improved organizational knowledge. Virtual Closes and One-Day Reporting are important advances in making transaction process more efficient. However, Finance adds the greatest value when it assists information consumers and decision makers in convert financial information into competitive knowledge and action. The “K” of the E2K measure is the prime value added activity of the finance function.

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