

Sarbanes Oxley Impact on Supply Chain Management

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Abstract. When the Sarbanes-Oxley act (SOX) was signed into law on July 30, 2002 it changed the way executives at nearly every public company thought about their business. While SOX gained attention in 2003 and 2004 for its focus on financial and accounting issues, the focus in 2005 and 2006 has shifted to other functional areas such as Supply Chain, Human Resources, and Information Technology. It is clear that this trend will continue, and for supply chain leaders, the time is right to establish an active role in your company's corporate governance strategies.

The SOX legislation brought the need to have transparency in financial statements to the forefront of corporate issues. And though many companies continue to look at SOX as a "Financial Department Issue", we will explore how our supply chain activities are directly involved and the impact that these have with our company's pursuit for SOX compliance.

Objective. This workshop will provide a high level overview of the key components and tenants of SOX and also outline the specific supply chain activities that have SOX implications.

Some Background and Highlights of the Sarbanes-Oxley Act (SOX)

The Sarbanes Oxley act was a direct result of the serious misconduct by business leaders in the late 1990's and early 2000's that hurt both large and small investors. The SEC chairman stated that "*SOX is essential in restoring investor confidence by providing transparency in financial reporting.*" And in retrospect, we now see that most of the abuse that occurred was simply forgetting or ignoring basic ethics and common sense.

So who does the SOX apply to?? Any company whose securities are registered and required to file reports under section 15(d) of the Exchange Act. In essence, any publicly traded company.

There are six key provisions of the act in which each company must:

1. Establish fully independent audit committees.
2. Wait one year before hiring an audit engagement team member to be a CEO, CFO, CAO or the equivalent.
3. Not extend loans to directors or corporate officers.
4. Make annual internal control reports.
5. Disclose information about material changes on a real time basis.
6. Establish "Whistleblower" protection for employees

And, the act established fines and penalties for specific wrongdoings and these are significant. Fines could be up to \$15 million and 25 years in prison for each offense. So why

all the concerned by those ethical and well intentioned CEO's and CFO's?? Because they must quarterly certify that their financial statements and controls are in compliance or they will face a career ending nightmare.

One question that is raised by almost everyone who has an interest in learning more about the act is *"OK, it is enacted legislation but who is going to oversee this activity?"* The act established the Public Company Accounting Oversight Board (PCAOB) to accomplish just this. This is a very powerful and influential board that is appointed by the SEC. They have the right and responsibility to oversee the auditors and audits of public companies and also are empowered to sanction both firms and individuals for violations. The board is funded via mandatory fees from the public companies and also from accounting firms who provide audit services.

The next logical question arises *"how are companies to document their findings?"* And the beauty of this answer lies at the heart of the intent of the act: there is NOT any standard form or series of forms to complete, but each company must report on a quarterly basis the following:

1. Design of controls over relevant financial statement assertions
2. Information about how significant transactions are initiated, recorded, processed and reported
3. Sufficient information to identify where material misstatements due to error or fraud could occur
4. Identify controls designed to prevent or detect fraud – including who performs them and the related segregation of duties
5. Controls over period-end financial reporting processes
6. Controls over safeguarding of assets
7. Results of management's testing and evaluation

And the key to this report documentation is that the act does NOT provide a definition of "relevant" or "material" and each company must decide as to what is relevant or material based on each circumstance. From the previous section on fines and penalties, you can now see where CEO's and CFO's will want to err on the side of safety and will more than likely convey any information to the PCAOB that they feel could be construed as negative.

Why Should Supply Chain Leadership Need to be Engaged in Understand SOX??

CEO's are going to turn to Supply Chain leaders to take a proactive approach in corporate governance. They realize that passing audits is just one part of this new approach and that only those who work in supply chain organizations fully understand the issues at hand within the inter-workings of supply chain controls of the company. We have seen a migration and mindset of supply chain organizations working closely with Auditing departments now that SOX is in full view vs. our previous attitude of trying to steer our internal auditing friends away from known problem areas. And finally and most importantly, SOX is the Supply Chain Leader's opportunity to achieve SCM Excellence for their department. With the emphasis on controls, systems, and streamlined processes, what better time for us in supply chain to build a case for obtaining those resources, systems, and tools to help us become more effective SCM organizations.

Three Sections of SOX that has Supply Chain Implications

The balance of this manuscript will be devoted to identifying specific supply chain activities where there is a definite SOX implication. The Supply Chain process begins with planning/requisitioning/approval process and then proceeds to sourcing. Once sourcing is completed with supplier selections and agreements, it then proceeds to the material management link (warehousing, logistics and transportation) and finally ends at the point where we are paying the bills and providing our ultimate customers with finished products and services. SOX is evident at each of these activities, so let us now examine these.

I. Section 404: Internal Controls

SOX section 404 specifically requires that companies create and maintain viable controls. This section received the most attention for the past three years. The SEC has determined that controls beyond just Financial Controls are necessary and the following are specific supply chain issues that should be addressed by supply chain organizations.

(a.) Inventory and Inventory write-offs. Most supply chain organizations now have the inventory function as part of their responsibility. Inventories have been a major issue for those of us in supply chain for any length of time and having the time and resources to conduct inventory reconciliation has been a challenge. Too often, we put this off since it is not a priority and we can get to it later. No longer. SOX is very implicit that our financial records be accurate and timely. So, the SOX implication and questions from an inventory perspective are:

(1) Is the material actually there? As simple as it sounds, many of us continue to struggle with getting a handle on our inventory items to determine if they are still where they are suppose to be. If it's missing, are we correct in keeping it on the books as a financial asset?? No.

(2) Is the material value correctly stated?? What about the items we purchase for \$100 per unit, but now for whatever the reason (obsolescence, deterioration, etc.) is only worth \$50?? If we have them on the books for \$100, but their true market value is \$50 and IF we have NOT adjusted our inventory accounts to reflect this, then we are out of compliance to one of SOX basic tenets: Financial Transparency.

(3) Are the inventory items in our materials management system correctly conveyed and recorded in our Accounting system?? If not, then we have another Financial Transparency situation.

(b.) Material Transfers

The timely recording of material movements is now imperative because of SOX. If we are to achieve consistent, accurate, and timely reporting of financial data in our accounting system, then timely and accurate completion of material transfers is a key control issue. Even though the "completing the paperwork" has been a life long issue within supply chain organizations and traditionally we have stated that "it's not a priority" event, that is no longer the case if we are to meet the standards and intentions of SOX. We can certainly have great records within our materials management system, but if we are not diligent regarding the information flow to our financial system, then we are going to raise serious concerns regarding compliance. The

information in our materials management systems must be conveyed in a timely fashion to our financial system in order to see a current and accurate representation of our financial condition.

(c.) After the Fact Purchase Orders

All supply chain organizations, at one time or another, have “sanitized” purchases made by our internal clients when they have obtained goods or services outside established company policies and procedures. What SOX does require us to do is demonstrate that we are proactive in communicating to our internal clients the policies and procedures specific to requisitioning approval and procurement authority. And your CFO or Chief Compliance Officer will be interested in ensuring that internal controls are in place to ensure that policies and procedures are being followed and complied.

(d.) Segregation of Duties

One of the primary functions of SOX for internal controls is for companies to ensure that assets are safeguarded. Within the supply chain function, we must be aware that those individuals authorized to procure goods and services are not the same individuals who are receiving and paying the invoice. Our supply chain responsibilities will include ensuring that authorities and duties are sufficiently “separated” to the extent that opportunities for fraud and theft have been identified and controls put into place.

II. Section 401 (a): Off Balance Sheet Obligations

First thing that comes to mind when we mention off balance sheet obligations probably is Enron, WorldCom, and others who seemed to forget about basic accounting principles and practices. SOX specifically states that companies must show financial transparency and that all financial obligations can be seen by the viewing public.

We often do not relate this to supply chain but a closer examination will provide cause for rethinking how this is applicable to us. If any of our agreements we typically make in our day to day business have a financial obligation tied to an agreement, then we need to let our CFO or Chief Compliance Officers know what they are. They will normally determine to the extent of how they will be reported. Examples of this are:

- (1) Vendor Managed Inventories where we have a financial obligation to pay for cancellation or other penalties.
- (2) Long Term Purchase Agreements that have penalty clauses
- (3) Lease Agreements where there is a financial obligation to our company if we terminate the lease.
- (4) Letters of Intent where we commit to our supplier base in order to get in a long lead time production schedule. If there is a cancellation clause with financial impact, then this in essence is an off balance sheet transaction.

In each of the above examples, there must be a financial impact for this to be considered an off balance sheet transaction. A good business practice for us would be to keep our CFO and/or Chief Compliance Officer aware on a quarterly basis of all such agreements and a listing of these potential obligations that could result.

III. Section 409: Timely Reporting of Material Events

Sox calls for companies to report in a *timely* fashion events that will *materially impact financial reporting*. Generally, SOX does not give us guidelines on what is or is not a material event. The act leaves this to the discretion of the company and, as we have seen, CFO's and Chief Compliance Officers are sure to take the road of safety. But SOX does define "timely" as four days. So, if any of the following take place in your supply chain operations, you should convey this information to the CFO and/or Chief Compliance Officer to let them decide on the impact.

- (1) Late supplier deliveries that will cause revenue forecast to be missed.
- (2) Outsource providers who can not provide the goods and services which will result in missed statement of revenues based on relying on provider's services to continue to produce the revenue stream.

SUMMARY

Sarbanes-Oxley is here to stay and, as supply chain leaders, we should take advantage of the opportunity for our supply chain organizations to strive for excellence. What better time to seek the resources, systems, and tools we need in order for us to ensure efficiency and accuracy in our responsibilities. Heretofore, our company budget leaders may have been reluctant to approve these additional resources (whether people or dollars), but our compelling business case for achieving SCM excellence has received a major boost from the fallout and implications of SOX. We are now in a great position to market our needs to senior management and to continue our quest of achieving SCM excellence.