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Sarbanes-Oxley / Bill 198 and the Procurement Function.

Presentation to Corporation des approvisionneurs du Québec (CAQ) –
West Island District

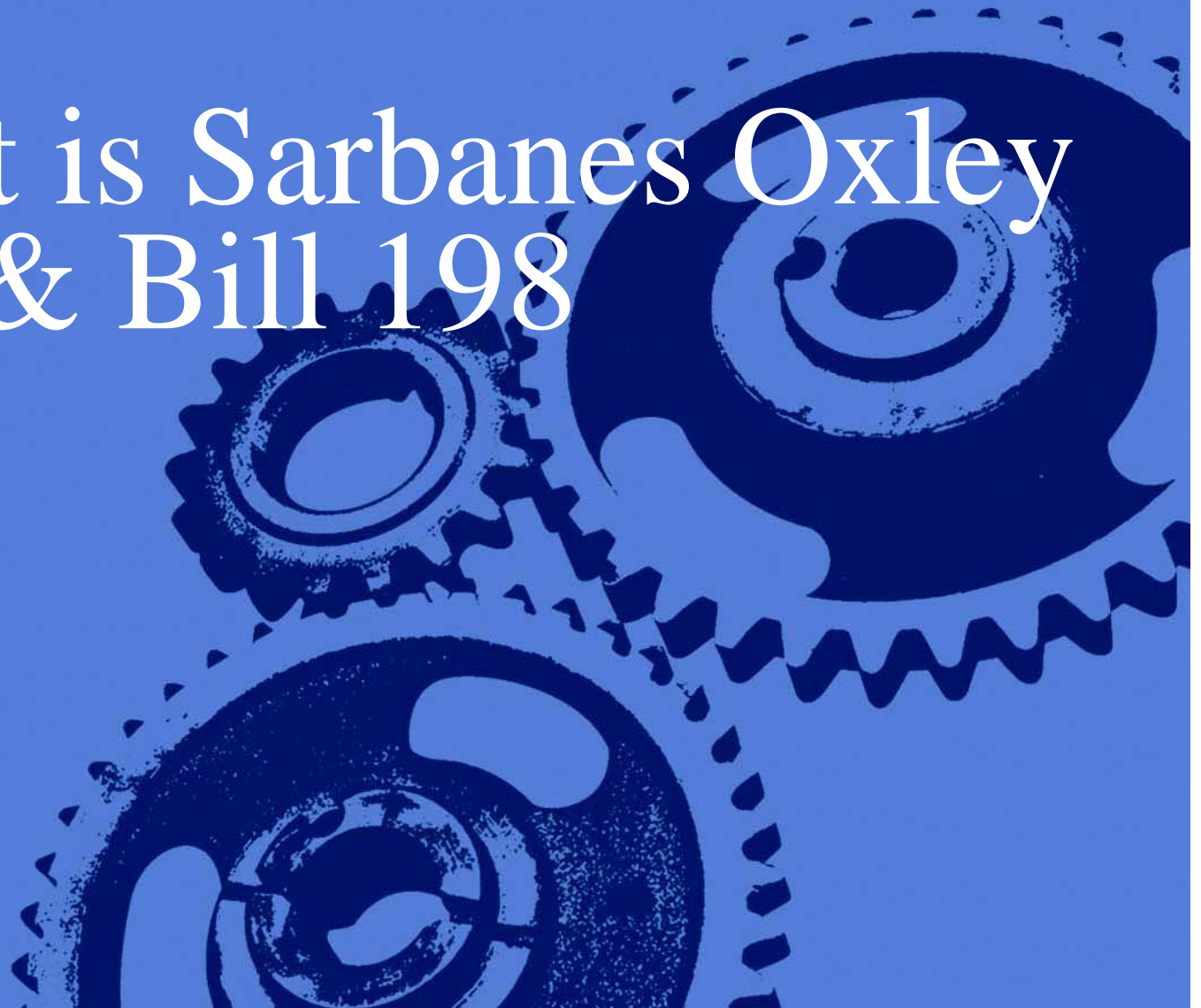
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Audit • Tax • Consulting • Financial Advisory.

Topics of interest

- Understanding what is SOX / Bill 198.
- Understanding basic concepts of SOX / Bill 198
- How it is related to the procurement function.
- How it affects the procurement function
- Dealing with vendors
- Anti-fraud consideration for the procurement function
- Final thoughts

So what is Sarbanes Oxley (SOX) & Bill 198



How did we get here?

- Unexpected large bankruptcies and business failures in US and Canada due to accounting errors
- Erosion of investor confidence
- Accounting errors in many cases due to poor corporate governance and poor internal controls over financial reporting

What is Sarbanes Oxley & Bill 198

- Sarbanes Oxley (USA) and Bill 198 (Canada) are laws
- Sarbanes Oxley Act became law in 2002 giving powers to the SEC to issue new rules and impose penalties and criminal charges for non-compliance.
- Bill 198 was passed into law in Ontario that gave similar powers to the Canadian Securities Administrators – CSA (includes Ontario Securities Commission).
- American rules and Canadian rules are generally similar with one important difference (based on proposed rules)
- In US and Canada several rules issued that affect different aspects of both corporate governance and financial reporting

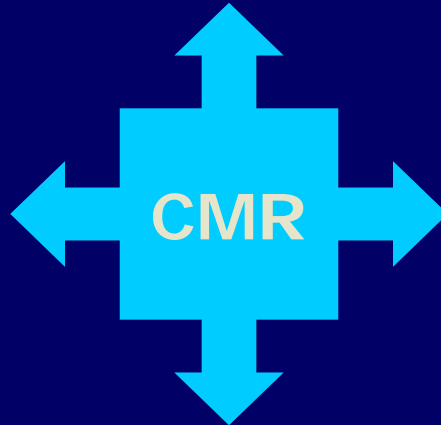
Four Areas of Capital Market Reform

Audit Committees

- Independence of Members
- Financial Literacy and AC Financial Expert
- Relationship with External Auditors

Regulation of Auditors

- CPAB (quality)
- Auditor Independence



Management

- Accounting Standards
- Continuous Disclosure
- MD&A
- **CEO and CFO Certification**
 - Disclosure Procedures
 - **Controls over Financial Reporting**

Penalties

- Fines and Sanctions
- Disgorgement
- Civil Liability for Disclosures in Secondary Markets

Objectives of SOX & Bill 198

- Restore the public's confidence in the securities marketplace by:
 - Improving the corporate governance of public companies
 - Improve quality and transparency of information issued by public companies (financial statements and other disclosures)

Basic concepts of SOX and Bill 198



Regulatory Requirements

- CEO and CFO are required by the regulators to certify in writing that the system of controls over the information disclosed to the public and the internal controls related to ***Financial Reporting*** are:
 - Adequately designed to prevent & detect errors
 - Operate effectively – actually working as designed
- The certifications will be required quarterly and annually - therefore an ongoing activity - unlike Y2K projects
- For SOX, the assessment or evaluation performed by the CEO/CFO is audited as well as an independent audit of the internal controls.
- In Canada new proposed requirements (March 10th, 2006) will not specifically require an audit of internal controls.

ICFR Definition


- “Internal control over financial reporting” means a **process designed by, or under the supervision of, the company’s CEO and CFO**, or persons performing similar functions, and **effected by** the company’s board of directors, **management and other personnel**, to provide reasonable assurance regarding the **reliability of financial reporting and the preparation of financial statements** for external purposes in accordance with the issuer’s GAAP and includes those policies and procedures that:

ICFR Definition (Continued)

- pertain to the **maintenance of records** that in reasonable detail **accurately and fairly reflect the transactions** and dispositions of the assets of the issuer,
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the issuer's GAAP, and that receipts and **expenditures of the issuer are being made only in accordance with authorizations of management** and directors of the issuer, and
- provide reasonable assurance regarding **prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets** that could have a material effect on the annual financial statements or interim financial statements."

Key Points

- Key Points to remember about CEO/CFO certification & ICFR:
 - CEO / CFO ultimately responsible to ensure system of internal controls are adequately designed into processes and operate effectively. They are **personally certifying** this to the public.
 - This **responsibility** is usually **delegated downwards** to the management team to design, implement, execute and monitor the processes and internal controls.

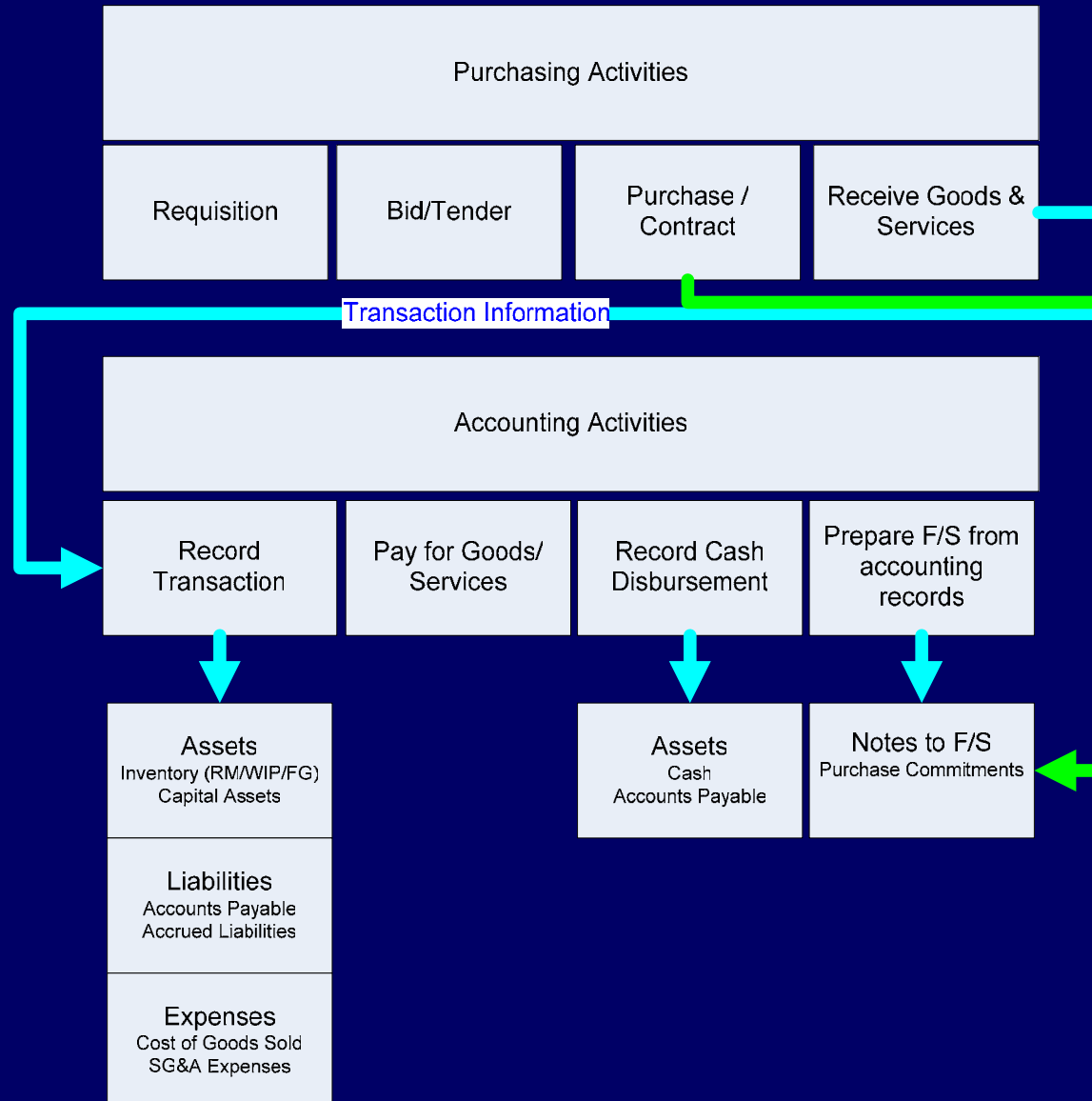


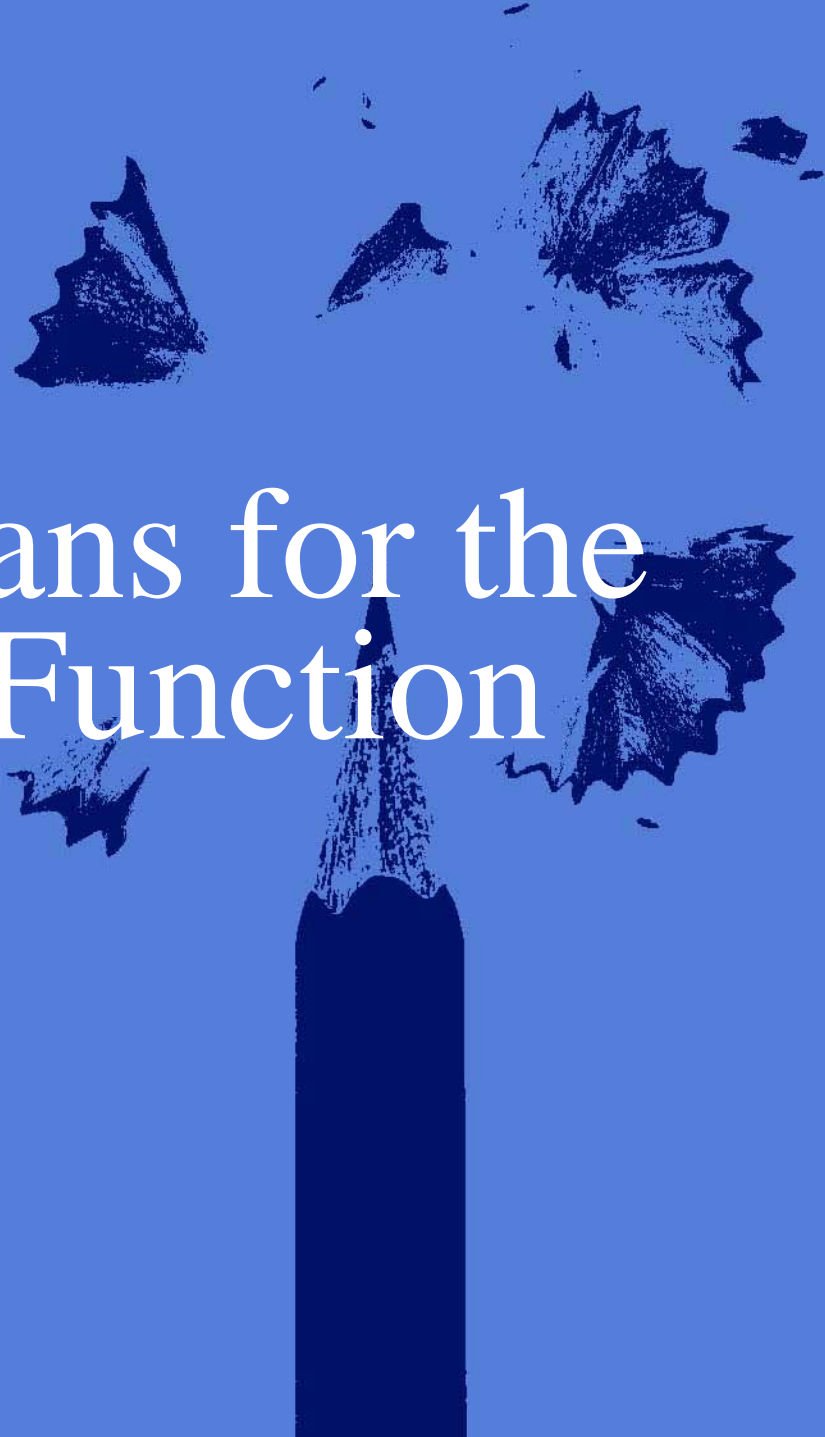
Why procurement is important to CEO/CFO Certification

Importance of Procurement

- Transactions (number, size and impact on Financial Statements) flow through the procurement function activities that have a direct and material impact on financial statements.
- Information about transactions is usually generated and initially recorded by procurement activities. This information is used by Accounting & Finance to prepare F/S and disclose other relevant information to public.
 - Procurement and accounting systems are integrated in many cases (ERP systems – i.e. SAP)
- Management of the procurement function are often delegated the responsibility to ensure internal controls affecting ICFR are adequately designed and effective.

Relationship Purchasing/Accounting





What this means for the Procurement Function

What does this mean for you?

- Dealing with your company's internal CEO/CFO certification project
- Potential changes to your procurement procedures
- Changes in dealing with your vendors and changes in your vendors procedures

Your Company's internal SOX/198 project

- CEO/CFO need to demonstrate due diligence in evaluating the design and effectiveness of internal controls in each significant area.
- Some of the related activities to show the due diligence exercised by management
 - Documentation of current processes and internal controls
 - Remediation where controls are inadequate to meet objectives
 - Controls are tested to validate that they work
- As noted in the basic concepts section - not a one time event
 - Documentation of processes generally done yr 1
 - Testing will have to be done annually
 - Changes in processes will have to be captured and evaluated for proper internal control.

What does this mean for you?

- Possible sub-certification by Purchasing managers to CEO/CFO.
- Preparation of process and internal control documentation
- Potential changes to your procurement procedures
 - Formalization of existing /Development of procurement procedures
 - Formalization of existing/ Development of Procurement Code of Conduct.
 - Procurement personnel sign off of Code of Conduct
 - Better documentation of purchasing and contracting decisions
 - More rigorous contract negotiation and contract review procedures
 - Change in duties to improve segregation of duties
 - If US subsidiary dealing with international vendors - comply with Foreign Corrupt Practices Act

Dealing with vendors

- Educate vendors on your procurement Code of Conduct to avoid future problems
- Proactively Communicate with vendors re: changes in your procedures and any new requirement - should be explained not as required by SOX but as new procedures to improve and enhance the company's risk management procedures in procurement area
- Your purchasing process = vendor's sales process
- If public company - have own risks and related internal controls to cover from Sales perspective:
 - i.e. More formalized procedures for accepting orders or providing quotes or more formalized contracting process

Some key risk areas

- Biggest risks related to non-standard or custom contract terms and conditions
 - Impacts vendor's revenue recognition
 - Impacts recognition of your assets and liabilities
 - Existence of contingent liabilities (i.e. minimum purchase commitments) or possible areas of future litigation
 - Accounting impact of volume rebates
- Large purchases before certain dates (end of vendors period end – quarter or year end)
- Dealing with gifts and independence of buyers (perhaps changes in who you have been dealing with)

Vendor business practices

- Possible requests confirmation/reconciliation of their receivables – your payables
- Change of shipping terms (FOB destination vs. FOB shipping) – how is this related to SOX
- The end of deals at quarter end – how is this related to SOX

SOX/198 – Fraud and the Procurement Process



Why talk about Fraud?

“At any given moment, there is a certain percentage of the population that’s up to no good.”

J. Edgar Hoover



How is fraud related to SOX/Bill 198

- Requirement that anti-fraud programs need to be in place.
 - Anti-fraud controls to prevent/detect possible types of fraud
 - Procurement is a significant process where much of the company's cash and disbursements are directly related – inherently any area related to cash or assets is where most internal fraud has occurred at companies.
 - Any evaluation of the internal controls in procurement needs to consider risks of fraud
- Effect of Fraud on Financial Statements/Disclosures
 - Overstatement of the value of assets
 - Unrecorded or undervalued liabilities
 - Omission or inaccurate disclosure of significant information to public
 - Unrecorded potential legal liabilities
 - Impact on overall control environment and system of control

Types of fraud schemes

- External fraud
 - Theft of company assets (cash, physical or intellectual property) by third party
- Internal fraud for personal gain of an employee
 - Misappropriation (theft or other scheme) of company assets
 - Improper or unauthorized expenditures (including bribery and other improper payment schemes)
 - Kickback schemes
- Fraud / Illegal activities performed by an employee for the company's gain – Improve financial results or protect share price - exposes individual and company to legal liabilities (regulatory or criminal)
 - Misrepresenting transactions for benefit of company's profitability
 - Omission of disclosure of relevant information that would have negative impact

Examples of Procurement Frauds

- Fictitious vendors
- Kickback schemes
- Rigged bidding/quotation
- Phantom billing
- Vendor over billing
- Product substitutions
- Side contracts/agreements
- Not recording transactions (i.e. not receiving goods)
- Recording invalid transactions (i.e. channel stuffing – ship/return arrangements).
- Inappropriate changes of contract terms on documents that impacts accounting treatment
- Unauthorized purchases for personal use
- Asset redirection (for personal gain)

Are you Ready for Sarbanes-Oxley / Bill 198



Is your procurement function ready

- Has there been an assessment of the various points where errors or fraud could occur (inherent risk points) – are adequate controls in place?
- How strong is the overall control environment
 - Strong tone from management on importance of controls & ethics?
 - Is there a whistleblower process in place to report fraud ?
 - Well trained and competent procurement staff?
 - Are limits of authority clearly laid out and does procurement staff understands these limits?
- Is there a disciplined and rigorous procurement/contracting methodology and procedures in place
- Does procurement have it own formal guidelines as to ethics and Code of Conduct (i.e. Independence, Gifts from vendors) – are they enforced

Last Thoughts

- Understand the “big picture” – Procurement is important to the company, financial statements and information released to the investor community.
- Assess your risk of errors and fraud – understand where controls should be to prevent and detect errors or fraud
- Create awareness of why the CEO/CFO certification project is important and not just an administrative or accounting requirement.
- Procurement management should be proactive and take ownership of the internal controls in procurement activities – be involved in your company’s internal SOX/198 project and use the internal expertise
- See this as an opportunity to improve the procurement functions efficiency and ability to manage risks to the company
 - Many companies seeing this as the catalyst to drive changes
 - Improved risk management
 - find potential risk management gaps and efficiency improvements

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