

SARBANES-OXLEY SIMPLIFIED

REMOVE MATERIAL WEAKNESSES IN INVENTORY & ASSET CONTROL

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SOX INTERNAL CONTROL - INTRODUCTION

The Sarbanes-Oxley Act of 2002 (“SOX”) puts a new emphasis on timeliness and transparency in financial reporting, and the importance of internal controls in managing a public company. As of November 2004, SOX became a requirement for larger companies traded on a U.S. stock exchange; smaller public companies have until July 2007 to comply.

This whitepaper provides an overview of, and solutions to, the “quality and timeliness” required by SOX Sections 404 and 409, with a focus on one of the most common areas where weakness in internal controls is found within companies: inventories stored in open environments where use is not monitored or managed. The range of assets stored in these environments – safety materials, spare parts, MRO, consumables, tools, test equipment and other business support items – often represent 50% of balance sheet assets in industries such as manufacturing. As such, these types of assets and inventory represent a very significant area of operational and financial risk. However, with the right processes and supporting technology, the path to SOX readiness for managers charged with these items can be smoother and easier on the budget.

A fundamental source of SOX guidance used by both auditors and judges evaluating SOX compliance is the Committee of Sponsoring Organizations’ (COSO) “Internal Control Framework.”¹ COSO is a landmark view of internal control, in that it extends beyond financial checks and balances to include:

- Operational activities including business process control

- The impact of information systems and data quality in enforcing business process and serving as evidence of control
- The “Tone at the Top” control environment established by managers and company culture

Importantly, COSO defines internal control as a process in and of itself:

Internal control is broadly defined as a process, effected by an entity's board of directors, management and employees, designed to provide reasonable assurance regarding the achievement of objectives in: effectiveness and efficiency of operations; reliability of financial reporting; compliance with laws and regulations¹

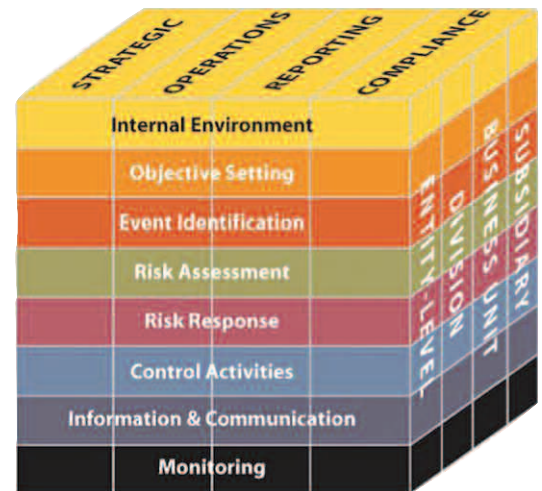
SOX INTERNAL CONTROL – The Quality & Timeliness Factor

By including operational as well as financial considerations, SOX raises the bar for the quality of information that feeds the balance sheet and emphasizes “transparency,” which refers to the extent to which the health of the organization is made clear to all individuals relying on financial reports.

“...executives are under pressure at companies everywhere to meet financial goals, and they face temptations each quarter...”

– Jeffrey Sonnenfeld, Yale School of Management, on internal control over inventory reporting

What makes SOX stand out from earlier standards is the requirement for senior management and auditors to attest to the strength of internal controls and business process.² Through the COSO lens, SOX



The COSO “Cube”

reaches every corner of an organization down to the lowest level employee, as the trickle down effect of internal control in hourly operations becomes important to overall financial reporting. Given the broad modern definition of internal control to include quality in both operations and financial reporting, managers must now consider how the enterprise is operating at all levels to prevent, or at least disclose, “material weaknesses” in control.



Material weaknesses³ in internal controls are not allowed by SOX, and must be disclosed. Also required to be disclosed are any acts of fraud that involve management or other employees who have a significant role in the internal control over financial reporting.⁴ Inventory accounts receive greater scrutiny under this new requirement to detect the following quality of

information gaps that create poor internal control:

- Lack of accountability over item usage
- Lack of accountability over item ordering
- Inaccurate inventory & asset information
- Inadequate asset & inventory information

The most common account-specific material weaknesses occur in the current accrual accounts, such as accounts receivable and inventory. - Accounting Horizons, September 2005, a publication of the American Accounting Association

The penalties for breaching SOX rules are severe: fines of up to \$5,000,000 and 20 years' imprisonment. From an auditor's perspective, inventory and assets, as an "Account Specific" area of review is among the most deficient areas of internal control:

tant, the timeliness of when inventory is reported can be just as critical and is a significant consideration of Section 409 of SOX⁵. From a SOX perspective, delayed reporting exposes a company to:

- Excessive purchasing of assets already on-hand and potential future write-offs
- Poor reporting on the age of assets and thus depreciation and valuation errors
- Excessive expensing because inventory- and asset-intensive processes are not efficient or controlled

THE UNIQUE SOX CHALLENGE IN OPEN AND UNMONITORED ENVIRONMENTS

The purpose of SOX is to assure a control environment that delivers predictable achievement of operational objectives and thus financial results. In contrast, many

and when discovered, can immediately swell balance sheet inventories

- Overall inventory reporting is manual and uncoordinated in most companies with multi-site operations creating errors and slow reporting (phone, clipboard, delivery notices, email, spreadsheet, ERP manual data entry).

Moreover, many items can be subject to obsolescence, and thus a widely varying value over time – some obsolete parts can be worth ten times their original price when scarce – affecting the recordable value if not reported quickly. Additionally, the increasing existence of secondary markets, such as eBay, for items increases the potential for employee theft and fraud. With this much potential risk, the timeliness and quality of inventory reporting is particularly critical for any inventory and asset not monitored by the organization.

SIMPLIFY SOX – SOLVING THE CHALLENGES WITH TECHNOLOGY

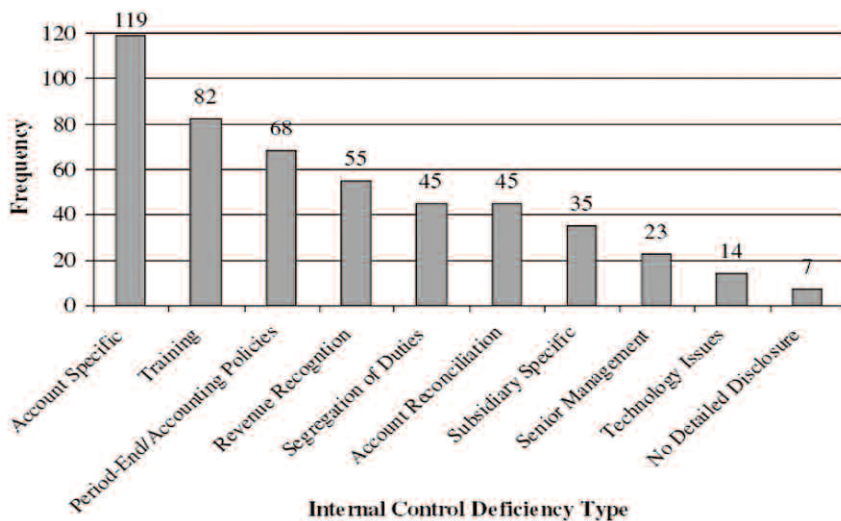
Without improved internal control over service inventory, publicly traded companies place themselves at risk of non-compliance with SOX, and they may lose an opportunity to improve their margins and market share. Technology can help.

Technology can bring real-time visibility and reporting where ad hoc or periodic counts were previously relied upon. Counting is resource intensive and often accompanied by manual account reconciliation. Manual solutions are typically less timely and more inherent for error. Physical counts can also conflict with segregation of duties because they are often performed by the people who used the inventory. With the help of technology, stock can be continuously tracked and the scope of the physical counts can be reduced.

Technology can expose discrepancies as they occur and provide an audit trail to help pinpoint control deficiencies and/or personnel breakdowns. These features are critical for the reporting accuracy (and swift corrections) required for Sarbanes-Oxley compliance; a favorable side-effect is a reduced scope and cost of the external audit.

Technology also can create a control environment and set a managerial "tone" for the way inventory is used and managed. Using technology to support inventory control also may speed the road to process documentation – another Sarbanes-Oxley requirement.

Technology can improve an organiza-



Inventory-based material weaknesses are also often found by auditors in Segregation of Duties, Technology Issues and Account Reconciliation categories. Auditors – Internal Auditors in particular – are charged with determining the overall definition and state of business processes that consume and/or manage assets and inventory. Below is a sample from a standard COSO-based audit plan:

While accurate information is impor-

inventory and asset environments are open – item use is not always metered, measured or controlled. These environments often create suspect and risky control environments that auditors are now being tasked with targeting:

- Inventory and asset ordering and subsequent use is often at the sole discretion of individuals
- Returns, repairable items and inventory under warranty are infrequently reported

Internal Control Deficiencies	Sample Audit Questions
• Segregation of Duties	Who is using and reporting the assets? Describe processes that separate item use from item purchasing.
• Technology Issues	Do systems of record reflect accurately on-hand and available items? Describe the business process for assuring this.
• Account Reconciliation	How is inventory counted reconciled accurately? How is it valued? How frequently does it occur?

SOX Challenge

Item Accuracy
Inventory Timeliness
Inventory Quality
Inventory Accountability
Inventory Audit Trail
Reconciliations
Data Audit Trail
Unpredictable Inventory
Theft or Shrinkage
Segregation of Duties
Inventory at Remote Sites
Inventory Security

Technology Consideration

Barcode scanning or RFID
Real-time transaction reporting
Centralized, on-demand view of current inventory
Individual employees tied to inventory usage
Time and employee stamp on inventory use & return
Ability to directly reconcile
Time and individual usage stamp on inventory changes & reconciliation
Need Consumption analysis & planning tools
Inventory security
Role-based inventory access, usage and data change privileges
Wireless and/or Internet-based communications to inventory scanning tools
SSL or similar bank-grade data security; PIN codes or keycards for inventory security systems

Things to consider in evaluating the SOX-readiness of your service parts infrastructure

tion's readiness for SOX 404 (quality/internal control) and SOX 409 (timeliness) in the critical areas of business process control, financial reporting integration, audit trail and security. Without the right technology, manual and/or spreadsheet based reconciliations are often required between inventory control and financial reporting. Poorly controlled and slow reconciliation processes are commonly reported SOX material weaknesses. Reliance on spreadsheets to feed the financial reporting process is also commonly reported. Spreadsheets can become corrupted relatively easily and this is not usually detected swiftly. They also may not be properly version-controlled and do not, as a stand-alone spreadsheet application, capture the audit trail of changes, additions and deletions with reason, date, user and approval of the entry and final report. As a general concern, auditors note significant lack of centralized data for companies with widespread operating locations – making the overall financial reporting process risky and ripe for error.

There are technologies available to strengthen security and move an organization more swiftly toward SOX compliance. Examples of technical security and mechanisms that strengthen internal control include the use of a secure socket layer (SSL) in Web applications and several levels of authentication including strong passwords, PINs, smartcards and biometric devices.

How technology is accessed is important. In most organizations, there are multiple ways of accessing financially-reportable data. This is particularly troublesome as organizations struggle to comply

with sections 404 and 302 of SOX, which mandate that access controls are in place, segregation of duties are enforced and information is accurate. Inventory control solutions should support compliance for segregating inventory and asset visibility to the correctly authorized individuals.

People are most the critical part of SOX compliance. And technology can help those people do a better job and do it quickly. Automation can especially aid tracking and reconciliation functions. When inventory and assets are a significant item on the balance sheet, it may be impossible to meet the quality and timeliness requirements of SOX without the aid of technology.

Importantly, SOX reaches across an "extended enterprise," and so should your internal control capabilities. Technology can bring greater control to not only your internal environment but customer sites, forward stocks, partner sites, and supplier sites. Current technologies, such as barcodes and radio frequency identification (RFID) scanning combined with smartly designed monitoring and management software, offer affordable real-time control solutions and a way to create control and personnel accountability across all inventory and asset locations.

Bringing inventory and asset control and reporting in line with the new standards set by SOX is a challenge that is or will be faced by any company for which any unmonitored asset or inventory is a significant aspect of the overall business. Currently available technologies can ease the burden of compliance and, at the same time, bring operating efficiency and competitive advantage to the organization.

SOX Success Story – ABB Ltd.

ABB Ltd. is a \$24B provider of power and industrial automation products & services. ABB's SmartSpares™ solution, powered by technology from San Mateo, California-based SeeControl, provides an example of the return on investment that can be achieved through SOX-ready automation of spares and MRO inventory management. The SmartSpares™ solution also improves the SOX-readiness of ABB's customers since it is also deployed to this area of ABB's "extended enterprise." Using barcode scanning to track part usage and trigger automatic replenishment at both internal and external sites, significantly reduced the previously manual process of managing and reconciling inventory – from 3.5 days to 2 hours per week (SOX timeliness). ABB also improved inventory accuracy to 100% while also reducing inventory shrinkage from 3% to .1% (SOX quality/health). ABB was also able to reduce overall inventories by \$2 million and the risk of excess ordering of parts and materials through the auto-replenishment program. Additionally, productivity was doubled while theft and shrinkage were reduced to 0.1%. □

1 COSO Internal Control - Integrated Framework 1997; Draft COSO Internal Control – Integrated Framework Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting October 2005. See www.coso.org.

2 SOX Section 404 "Management Assessment of Internal Controls" (includes Auditor attestation)

3 A material weakness creates a more than remote chance that a material misstatement will not be prevented or detected in a company's financial statements

4 SOX Section 302 "Corporate Responsibility for Financial Reports"

5 SOX Section 409 "Real Time Issuer Disclosures" outlines the significant events that must be reported within 4 business days to the SEC.

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