



SAP White Paper
SAP Solutions for E-Sourcing

SARBANES-OXLEY COMPLIANCE IN PROCUREMENT CONTRACTS, TODAY AND TOMORROW

**A Blueprint for Ensuring Contract Compliance and Anticipating
Future Requirements**

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EXECUTIVE SUMMARY

The spirit of the Sarbanes-Oxley Act (SOX) calls for risk controls on both your suppliers and your contracts with those suppliers. However, the right approach to complying with SOX has been cause for much discussion among procurement, supply chain, corporate audit, information technology, and CFO organizations.

For those sections that most directly impact the supply base, companies are working to define, then refine, their compliance procedures using interpretations of the law. In the future, court litigation is sure to create precedents that further define concepts such as “appropriate” controls and “materiality” of breaches, and enterprises will have a new generation of processes to implement.

Until then, some obvious controls such as antifraud measures are certain to be required under the act. But core controls – such as preventing employees from setting themselves up as a vendor and cutting themselves a check – are already in place at most companies using their financial accounting systems.

What new or improved control processes are needed? The law’s lack of clarity could lead you to believe that nothing else needs to be done. This assumption carries risk and ignores the business value of compliance when done right. If you believe supplier relationship management (SRM) processes are important, then paying attention to controls is “appropriate” and “material” regardless of the clarity of the law. In some cases, you will need to implement new processes. In other cases, you can automate existing processes to allow for measurement, auditing, and reporting.

What’s exciting about this era is that two forces have emerged at once and provide a great catalyst for you to talk to your enterprise about supplier relationship management. First, new laws such as SOX can serve as change agents. Second, automation of your key supplier management processes simplifies your compliance efforts and can unleash hidden business value.

SARBANES-OXLEY ACT DEFINED

Many of the sections of the law have tangential applicability to procurement and suppliers. However, the following three sections have direct linkage to your management of suppliers.

Section 401 (a): Contractual Obligation Reporting

In 2003 the U.S. Securities and Exchange Commission published *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, Release Nos. 33-8182; 34-47264 at www.sec.gov/rules/final/33-8182.htm.

As an implementation of Section 401(a) of SOX, this regulation provides a specific format for reporting future purchase obligations for which your company has done the following:

- Made a purchase commitment of either fixed or minimum quantity that is noncancelable
- Made a purchase commitment with a cancellation penalty
- Made a purchase commitment with a payment obligation even if no goods or services are received

The following illustrates an example of the filing format.

	Payments Due by Period				
	Total	2006	2007-2008	2009-2010	2011 and Thereafter
Aggregate Contractual Obligations. As of December 31, 2005, the company's contractual obligations, including payments due by period, were as follows (in millions):					
Short-term loans and notes payable:					
Commercial paper borrowings	\$ 2,831	\$ 2,831	\$ ---	\$ ---	\$ ---
Lines of credit and other short-term borrowings	352	352	---	---	---
Current maturities of long-term debt	42	42	---	---	---
Long-term debt, net of current maturities	1,048	---	82	392	574
Estimated interest payments	989	65	120	115	689
Marketing and other commitments	3,956	1,243	910	584	1,219
Purchase commitments	5,674	2,460	1,014	526	1,674
Other long-term liabilities:					
Liability to shareholders	1,119	1,119	---	---	---
Miscellaneous	501	178	146	86	91
Total contractual obligations	\$ 16,512	\$ 8,290	\$ 2,272	\$ 1,703	\$ 4,247

Figure: A Sample 2005 Annual Report (SEC 10-K) Showing Compliance to Contractual Obligation Reporting

Section 404: Controls

According to KPMG, Section 404 “requires that management document and assess internal control over financial reporting, report on the assessment, and subject the assessment to audit by the organization’s independent auditor.” Thus Section 404 calls for a set of controls to monitor the potential impact of suppliers on the financial condition of your company.

Section 409: Timely Disclosure

Once a control process has been established, SOX calls for timely disclosure of “material” breaches of that control. In some cases, “timely disclosure” might mean reporting in as little as 48 hours.

As stated above, a strict definition of materiality cannot be expected until well into the future and will probably be based on court rulings. In the meantime, each company will need to develop its own policies on materiality and associated timeliness.

WHAT DOES SOX MEAN FOR PROCUREMENT?

In the absence of court precedents, the interpretation of SOX has been the domain of consultants and internal policy makers. Most often, the advisory arms of audit firms such as Deloitte and Ernst & Young have supplied guidance to internal groups such as corporate audit and SOX task forces. Those internal teams then bring SOX requirements to business functions such as procurement.

It's important for procurement organizations to stay close to the internal policy makers. Interpretation of SOX continues to evolve and you'll want as much advance notice as possible on future requirements. This way you'll have ample time to plan for new compliance requirements.

Section 401(a): Contractual Obligation Reporting

Compliance with this requirement means that you must have visibility into all supplier contracts to make determinations about future commitments. Most organizations have concluded that ensuring compliance requires a single, comprehensive electronic repository of supplier contracts. They have also recognized that a repository ensures that all supporting documents and data are in place to support audit requirements, and can ease the administrative burden of reporting.

A repository is also tied to a process, because contracts will constantly expire, renew, and be created. Therefore, a reliable process that captures contract changes into the repository can be a key means to ensure compliance.

Section 404: Controls

As stated above, SOX doesn't yet define exactly what controls organizations need to implement. That said, some controls are more obvious than others and you probably already have those in place. Existing controls might include:

- Fraudulent payment prevention
- Inventory loss prevention
- Purchase commitment authority by currency value
- Contract signature authority

But consider all of the dimensions of supply-base management: cost, quality, value, and risk. It's the less obvious controls that deserve your consideration, especially since these carry unforeseen – and traditionally unmanaged – risks. These risks include:

- Use of nonstandard contract terms
- Suppliers' lack of business continuity plans
- Suppliers' financial viability
- Product recalls based on supplier component failures
- Suppliers' misuse of labor
- Supply chain disruption, physical or electronic
- Missed service levels
- High reliance on offshore supply or even a single country
- Sole-sourcing strategies
- Distributed or uncoordinated supplier management across your enterprise

For example, many companies are implementing contract-approval workflows to ensure that:

- The right terms and conditions are included in a contract document.
- The right persons approved any exceptions.
- The right person signs the contract.
- The process isn't gamed with contracts just shy of dollar limits.
- The right persons can order from the contract.

Another example of controls is related to supplier risk. In the strategic tier of your supply base, you may want to measure financial viability on a quarterly basis to provide early detection of future issues. Using an SRM system to automate these controls can ensure that the following takes place:

- The activity is defined.
- An owner is assigned.
- The right data is collected.
- Action is prompted when values are unacceptable.
- A corrective action plan is implemented and documented.

Key success factors in the implementation of controls include frequency (are you doing it often enough?), assurance (can you make sure the control was followed?), and the ability to react to the adverse outcome of a process (do all of the people who need exception information actually receive it?).

Section 409: Timely Disclosure

Most organizations don't yet know which controls are subject to timeliness requirements beyond Section 401(a). And they don't know what "timeliness" means as it pertains to each control.

Therefore, they tend to take an ad hoc approach to dealing with adverse financial events such as product recalls.

Deploying an SRM system lays the groundwork for Section 409 compliance. Having clearly defined processes, timely measurements, and auditability will enable your organization to detect those events that could be material. You will then have the operational platform to rely on for exception reporting.

Mastering the governance processes related to Sections 404 and 409 is a challenge for most procurement organizations. These types of metrics are not aligned with the core savings-creation metrics by which procurement is commonly measured. In this respect, SOX is a valuable tool to increase awareness and shift procurement's charter to value creation and value protection.

One of the more notable recent examples of supplier disruption was reported by AMR Research on April 14, 2006: "The funeral proceedings of iconic Indian movie star Raj Kumar degenerated into widespread rioting in Bangalore, killing five. IBM, Infosys, Wipro, and other global services firms were forced to shut down their local facilities, highlighting the need for resiliency and redundancy in offshore operations. These three large providers have centers in many Indian cities and globally, but smaller firms operating principally out of Bangalore – there are dozens – would have been hard pressed to meet client obligations this week." What controls should have been in place? For one, the ability to move customer-supporting work processes from one locale to another without disruption.

ANTICIPATING WHERE SOX IS HEADED

With future litigation, SOX will be further defined in terms of which controls are needed and the materiality of breaches in those controls.

We predict that any supply-base risk that could impact your financials will require a corresponding control: one that is automated, auditable, and ensures timely exception reporting. This is well beyond the typical scope of supply-base management in practice today.

Companies are getting prepared by mastering core processes such as:

- Defining standards for supplier due diligence
- Segmenting supply base by risk profile; monitoring high-risk suppliers at regular intervals
- Identifying sole-source or single-source arrangements and defining risk mitigation strategies

GETTING STARTED

To begin laying the groundwork for future requirements, we recommend implementing the following phased approach to achieving compliance with SOX today:

1. Get and stay close to the policy makers.
2. Get your contract repository in order.
3. Introduce the basic workflow processes.
4. Refine your workflows based on category specifics.
5. Plan now for risk management controls.

CONCLUSION

One approach to SOX compliance is to do as little as required by your auditors. But this can create a false sense of security. Another approach is to use regulations like SOX as a catalyst to transform management of your supply base.

There are ways to use SOX to your near-term advantage. For example, if you have a robust supplier relationship management system, you can do the following:

- Enhance spend analysis
- Identify off-contract spend
- Stay apprised of future sourcing projects as contracts expire
- Use a workflow system to streamline contracting and minimize use of the legal department
- Create a reputation in your group as experts in getting contracts signed the right way

Try approaching SOX as an opportunity and not a curse. With a good strategy and thoughtful implementation, SOX can support your agenda of procurement transformation and value creation.

About SAP® Solutions for E-Sourcing

SAP offers comprehensive solutions for procurement contracts and workflow that can help you get started now. SAP® solutions for e-sourcing are hosted, Web-based offerings that help you maximize savings through fast, flexible, and sustainable sourcing. SAP solutions for e-sourcing encompass requests for proposals, reverse auctions, project management, contract management, spend analytics, and the workflow associated with these processes. With multiple solutions, deployment options, and support services, SAP addresses the supplier relationship management needs of your entire procurement organization – now and in the future.

The solutions help you attain bottom-line savings and accelerate time to benefit by cutting costs and encouraging user adoption. With SAP solutions for e-sourcing, your procurement operations can grow over time; when you're ready, you can easily and quickly move to other SAP solutions for e-sourcing and retain your existing investment.

If you would like to know more about SAP solutions for e-sourcing – and learn what they can do for your procurement organization – visit www.sap.com/srm/e-sourcing.

SOURCES

An excellent example of pre-SOX regulations on supply base governance can be found in:

- Office of the Comptroller of the Currency, Bulletin OCC 2001-47, *Third-Party Relationships*, November 1, 2001.
- U.S. Securities and Exchange Commission, *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, Release Nos. 33-8182; 34-47264, January 28, 2003, www.sec.gov/rules/final/33-8182.htm.

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