

COMMERCIAL RELATIONSHIPS BASED ON SELF-REPORTING

A new report by KPMG reveals that the annual value of trading relationships between companies that rely on trust and self-reporting may be at least \$300bn – and at least 70% of this is misreported. Such relationships are putting a strain on internal controls and compliance with Sarbanes-Oxley.

“There are only 7,000 people on our payroll, but more than 30,000 people actually work for us.” A report by KPMG says that this comment by the chief executive of a global software company is far from unique: the business comprises a network of suppliers, consultants, IT specialists and vendors. In this respect, the business has morphed into a “virtually integrated networked enterprise”, which relies on numerous self-reporting relationships. But according to KPMG, such relationships carry risks that are often overlooked or misunderstood.

And yet, at a time when regulators and stakeholders are demanding enhanced internal controls, there is growing evidence of the “invisibility” of such self-reporting relationships. Traditionally regarded as being the province of deals involving royalties or licensing fees, self-reporting can, in fact, underpin relationships with:

- Distributors
- Resellers
- Suppliers
- Co-marketers
- Creators and distributors of media content
- Outsourced manufacturers

● Contract labour

“Self-reporting relationships are operating at a dynamic and somewhat schizophrenic time in the global economy,” says the KPMG report. “Businesses seeking to reduce costs are disaggregating, outsourcing and forming self-reporting relationships with outside parties that are performing key functions which traditionally were part of internal operations. Such relationships are often risky from an internal control and financial perspective, and thus raise corporate governance and financial reporting issues. Three examples of these are:

- 1) A computer hardware manufacturer that reviewed warranty claims by its customers discovered a problem worth several hundred million dollars.
- 2) An audio components company found that it was owed \$35m in royalties when it discovered that a business partner had under-reported sales.
- 3) A petrol service station realised it was paying half a penny per gallon too much when it reviewed its ‘most favoured pricing’. The cost was tens of millions of dollars.

“The common thread,” according to KPMG, “[is that] each company had a self-reporting relationship with another business, based on trust, that was found to be misplaced.”

Being ripped off is not the cause of most errors, apparently. There are plenty of reasons other than fraud to explain discrepancies of this magnitude, including:

- Failure of both parties to devote enough resources to manage the contractual relationship.
- Systems weaknesses that may

exist within the organisation.

- Misunderstood, complex or ambiguous agreements.
- Failure to review self-reported information from a partner.
- Subsequent changes in circumstances, including corporate changes.

Auditing

The report states that self-reporting relationships should be properly audited, adding that few of the regular problems are picked up by the internal controls of the organisation receiving the report. Often, however, even when there is an audit clause in a contract, businesses are reluctant to enforce it for fear of damaging a key business relationship.

KPMG says, however, that invoking such a clause and recovering any additional money due sends out a message to other business partners that such reviews will be a routine part of doing business from now on. As a result, regular on-going audits of self-reporting relationships should eventually result in a reduced amount of additional money recovered – but, of course, an increased amount of money paid properly in the first place.

The report emphasises that the risks are not purely financial, but relate to risk management and regulatory issues such as compliance with the internal control provisions of Sarbanes-Oxley. Auditing the activities of a self-reporting partner in effect means they are scrutinised as thoroughly as your own. Moreover, over and above more accurate reporting and payments, such reviews may

identify possible enhancements to the business model.

In an appendix to its report, the firm interviews Joe Zier, a director in charge of corporate affairs at Hewlett-Packard. Zier says that audit clauses have been around for years, “only now there is a greater visibility into, and importance placed on, that process”. To most people, he says, monitoring a partner’s performance means “you have a conference call once a month and everything seems to be fine”.

Zier adds that the Sarbanes-Oxley Act has forced companies to look at their business and financial risks associated with reporting. “That same attitude should apply to contracts. The company should ask, ‘How are we managing our contracts?’” he says. “People generally say, ‘I don’t know what my real risks are around the contract.’”

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A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- ***The Self-Reporting Economy: A Matter of Transparency and Trust is available at www.kpmg.com***