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Audit of CANEX
Purchasing and Inventory Management

November 2010

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Canada 

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Acronyms and Abbreviations

A-FN-105	Policy and Procedures for Non-Public Funds Accounting
CAPI	Cost Accounting Perpetual Inventory
CANEX	Canadian Forces Exchange System
CDS	Chief of the Defence Staff
CF	Canadian Forces
CFO	Chief Financial Officer
CPO	CANEX Local Purchase Order
CRS	Chief Review Services
DGPFSS	Director General Personnel and Family Support Services
DMM	Director, Merchandising and Marketing
DPO	Distribution Purchase Order
E&SSM	Environmental and Security Services Manager
FOM	Field Operations Manager
FY	Fiscal Year
GP	Gross Profit
HQ	Headquarters
HR	Human Resources
IMR	Inventory Movement Report
IT	Information Technology
LPIR	Loss Prevention Incident Report
MOC	Military Occupation Code
MOSID	Military Occupational Structure Identification
MSP	Manager, Strategy and Plans
MW	Morale and Welfare
NATEX	NATO Exchange System
NATO	North Atlantic Treaty Organization
NM	National Manager
NMBDS	National Manager, Business Development and Services
NMCO	National Manager, Convenience Operations
NMLP	National Manager, Loss Prevention
NMRO	National Manager, Retail Operations
NPF	Non-Public Funds



NPP	Non-Public Property
OPI	Office of Primary Interest
PPTM	Policy, Procedures and Training Manager
PO	Purchase Order
POS	Point of Sale
RMF	Risk Management Framework
SMS	Store Management Suite
SOP	Standard Operating Procedures
TBD	To be Determined
V.P.	Vice President
WIS	Western Inventory Systems International



Results in Brief

In accordance with the Chief Review Services (CRS) Non-Public Property (NPP) Audit Group Work Plan for fiscal year (FY) 2007/08, an audit of Canadian Forces Exchange System (CANEX) Purchasing and Inventory Management was conducted.

The purpose of this audit is to provide assurance to the Chief of the Defence Staff (CDS) on the effectiveness and adequacy of the risk management, governance processes, and management controls that are in place to facilitate the efficient and cost-effective procurement of merchandise for resale and the adequacy of the management of CANEX's merchandise inventory.

Key Findings

Governance

- CANEX is meeting its mandate to provide members of the Canadian Forces (CF) and their families with a mix of goods and services available in progressive Canadian communities;
- Outdated policies and procedures at all levels are indicative of a need to further strengthen governance processes; and
- While, for the most part, the roles and responsibilities of CANEX's key positions are clearly defined and functioning as intended, the duties of the Environmental and Security Services Manager (E&SSM) and the Policies, Procedures, and Training Manager (PPTM) need to be re-evaluated.

Risk Management

- An overarching risk management framework (RMF) needs to be developed; and
- Gaps in oversight, analysis and procedures related to ||| and loss prevention are indicative of a need for strengthened strategic planning and direction.

Overall Assessment

Overall, CANEX's 2005 reorganization is having a positive effect on its operations. Senior management has instilled a strong operational focus, strategic planning improvements, and clear corporate priorities. There are, however, a few areas within the following topics that require attention:

- governance (policies and procedures);
- risk management; and
- the Store Management Suite (SMS) system.

The recommendations proposed should, when implemented, assist in safeguarding NPP assets and improve governance by ensuring that policies and procedures are current, relevant, and are being complied with.

Management Controls, Accountability, and Stewardship

- The supplier agreement negotiation and tracking process needs to be strengthened;
- The stocktaking process has been improved and, for the most part, is working effectively;
- Assurance as to the accuracy of average cost and merchandise inventory values in CANEX's SMS system cannot be provided; and
- Instances of inventory discrepancies identified during semi-annual stocktaking are not being consistently investigated.

Note: For a more detailed list of CRS recommendations and management response, please refer to [Annex A](#)—Management Action Plan.



Introduction

Background

CANEX was established in 1967 by the Defence Council and commercial operations began in 1968. In Ministerial Organization Order 4/90, dated 7 March 1990, the Minister of National Defence organized CANEX as a unit of the CF. Subsequently, on 30 October 1993, in Canadian Forces Organization Order 1.9, the Director General Force Development, on behalf of the CDS, announced CANEX's organizational status. Functional control of CANEX was exercised by the Assistant Deputy Minister (Personnel) via the Director General of Personnel Services. Following a series of reorganizations and name changes, CANEX's functional control is currently exercised by the Chief Military Personnel via the Director General Personnel and Family Support Services (DGPFSS).

CANEX has a mandate to provide the mix of goods and services generally available to Canadians living in progressive Canadian communities and required by members of the CF and their families.

In order to achieve this mandate, CANEX provides an extensive range of goods and services to members of the military community (i.e., authorized patrons¹). Through its chain of convenience and retail outlets, CANEX provides a wide range of merchandise, including men's, women's and children's clothing and footwear; furniture; major appliances; kitchenware; hardware; sporting goods; consumer electronics; groceries; health and beauty aids; magazines and newspapers; and petroleum products.

In addition, CANEX provides various goods and services through concessions, including barber shops and beauty salons, tailor shops, post offices, travel services, laundry and dry cleaning, pharmacies, medical and dental offices, real estate offices, credit unions, vending machines, and various food service outlets such as cafeterias, snack bars, Tim Hortons, and Subway. CANEX also provides special programs to its authorized patrons such as financing for a variety of "local products" such as car and truck tires, furniture, large appliances, insurance, and home heating oil.

Since 1985, CANEX has operated similar facilities for the North Atlantic Treaty Organization (NATO) in Geilenkirchen, Germany, as a division called the NATO Exchange System (NATEX).

As shown in Figure 1, the Vice President of NATEX, the Vice President of CANEX, the Manager, Strategy and Plans (MSP), and the National Manager, SMS/IT² Projects, report directly to the President of CANEX/NATEX. The DGPFSS' Human Resources (HR) Division also provides important services to CANEX as does DGPFSS' Chief Financial Officer (CFO), including a dedicated CANEX Management Accountant.

¹ A-PS-110-001/AG-002. Volume 1: Public Support for Morale and Welfare Programs and Non-Public Property, 23 March 2007.

² Store Management Suite/Information Technology (SMS/IT).

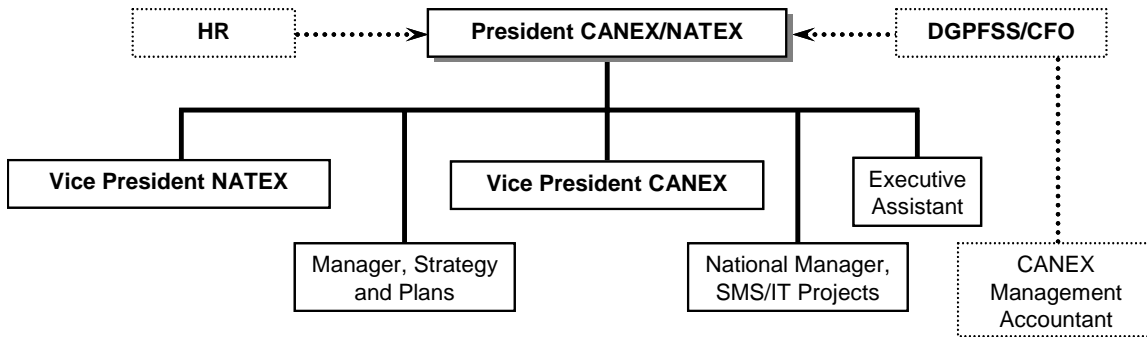


Figure 1. CANEX Organizational Structure (abridged). This abridged version of CANEX’s organizational structure shows the people who report directly to the President of CANEX/NATEX. It also illustrates that HR and the CFO provide important services to CANEX.

Figure 2 illustrates the high-level reporting relationships within CANEX. The National Manager, Business Development and Services (NMBDS), the Director, Merchandising and Marketing (DMM), the National Manager, Convenience Operations (NMCO), and the National Manager, Retail Operations (NMRO) all report directly to the CANEX Vice President. Both the NMCO and the NMRO have Field Operations Managers (FOM) reporting directly to them who are responsible for overseeing and supporting the operations of CANEX’s 26 convenience and 15 retail outlets.

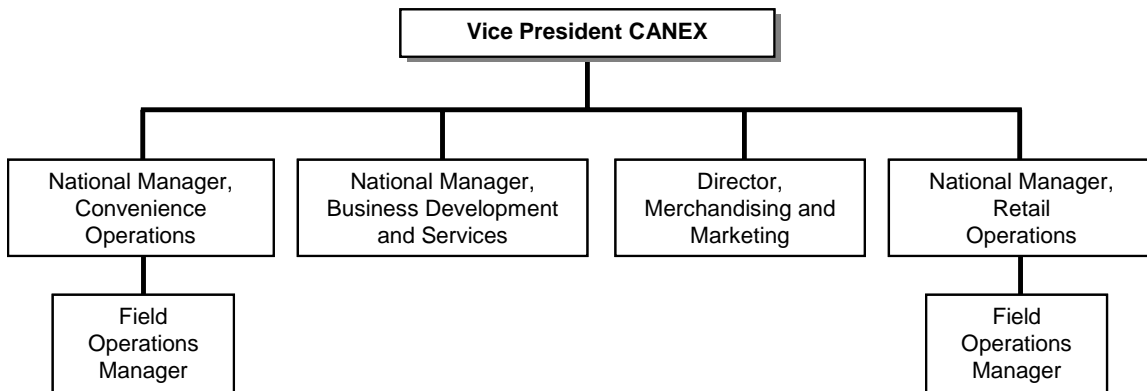


Figure 2. CANEX Organizational Structure (abridged). This abridged version of CANEX’s organizational structure shows the people who report directly to the CANEX Vice President. It also illustrates that both the NMCO and the NMRO have an FOM reporting to them.

The DMM’s responsibilities comprise the oversight of CANEX’s merchandising functions (including purchasing and central billing), advertising and sales promotion, and corporate programs. The NMBDS’ responsibilities include the delivery of services such as CANEX food services programs and contracts, concessions, environmental and security services, vending services, capital project planning, and infrastructure management.

Objective

The objective of this audit is to provide assurance to the CDS on the adequacy and effectiveness of the governance processes and the risk management and management control frameworks that CANEX has in place to facilitate the efficient and cost-effective procurement of merchandise for resale and the adequacy of the management of CANEX's merchandise inventory.

Scope

The audit's primary focus is on CANEX's procurement of merchandise for resale and the management of its merchandise inventory. The scope of the audit included only CANEX operations in Canada and, thus, does not include NATEX operations. CANEX's Gas Bar operations were excluded from the scope of this audit since it is a distinctly different business line with environmental issues. CANEX Gas Bar operations have been the subject of separate audits.

CANEX's inability to provide credible SMS information such as Inventory Movement Reports (IMR) limited the scope of the audit to the extent that assurance cannot be provided as to the accuracy of average cost and inventory value data provided by the SMS system.

Methodology

The following represents the general methodology employed for all four phases of the audit:

- Preliminary background research and review of governance structure, applicable processes, policies and procedures to assess their adequacy;
- Procurement process analysis using a purchasing cycle approach;
- Preliminary assessment of financial transactions and sample selection for testing;
- Review of supporting documentation for sampled transactions;
- Review of core inventory management processes and functions;
- Visits to CANEX HQ and 11 CANEX outlets at various bases/wings and a total of 25 interviews (13 at headquarters (HQ) and 12 on bases/wings);
- Analysis of sample data, monitoring reports, and stocktaking results;
- Review of RMF and documentation (stewardship—safeguarding of assets and loss prevention); and
- Follow-up questions and interviews.



Findings and Recommendations

Governance

Outdated policies and procedures at all levels are indicative of a need to strengthen governance processes.

Governance can be defined as the combination of processes and structures implemented by senior management to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives. Corporate governance includes the body of processes, policies and procedures that are put in place to guide the organization and ensure compliance with laws and regulations. Policies and procedures define roles and responsibilities and, as such, provide direction to staff.

The PPTM coordinates the development and maintenance of CANEX's internal policies and procedures while senior management determines priorities and provides direction. The maintenance and updating of the policy direction provided in the Policy and Procedures for Non-Public Funds Accounting (A-FN-105) that pertains to CANEX is the responsibility of DGPFSS' Accounting Policies and Procedures Analyst.

CANEX Standard Operating Procedures

The PPTM is responsible for bringing CANEX's Standard Operating Procedures (SOP) through the development cycle. In terms of process, CANEX's intention is to establish a formal policy development and approval process that mirrors the DGPFSS Information Services Division's proposed policy development framework.

To date, the PPTM has only set short-term priorities for SOP development. During FY 2008/09, the following were established:

- Shipper/Receiver SOP; and
- Stocktaking SOP.

The priorities and status of CANEX's policy and procedures initiatives for FY 2009/10, including expected completion dates, were as follows:

Priority	SOP	Status	Expected Completion Date
1	Clerk/Cashier	Implement SOP in stores	Completed
2	Store Cash Handling	Implement SOP in stores	Completed
3	Shipper/Receiver (French version)	Waiting for French-language content	TBD
4	Cost Accounting Perpetual Inventory (CAPI)	Waiting for final draft approval	Completed
5	Review of outdated CANEX policies	Pending	April 2011

Table 1. Status of CANEX SOP Development. This table lists the CANEX SOPs, in order of priority, that are under development or completed.

The PPTM's role is not to write policy and procedures; rather, the role is more one of coordination. The PPTM is focused on engaging, managing and liaising with external technical writers, including the generation of the Statement of Work and the solicitation of quotes from external suppliers. As demonstrated by CANEX's experience with outsourcing the development and writing of the Stocktaking and Shipper/Receiver SOPs, this is an effective option.

As of June 2009, the PPTM was spending about 75 percent of his time working on (i.e., administration and coordination) CANEX eUniversity. This is an effective web-based training and development tool. It has an extensive training module and course catalogue. All store managers and many of the staff at the CANEX outlets visited stated that they use this training tool often and praised it as an excellent learning resource.

In consideration of the significant amount of policy and procedures updating that is required, CANEX should undertake a cost-benefit analysis to determine the most appropriate way ahead.

Recommendation

CANEX should ensure that its SOPs are kept up to date and relevant.

OPIs: MSP and PPTM

CANEX Policy and Procedures Manual

The CANEX Policy and Procedures Manual is outdated. While the Operations section of the manual was last updated seven years ago, the Administration, Services, and Merchandising sections have not been updated in 12 years. In addition, the Merchandising section is not posted on the CFPSA website and, therefore, is not readily available to employees.

Outdated and irrelevant policies and procedures result in confusion regarding specific roles and responsibilities, inconsistent practices across the organization, inefficient operations, increased risks of loss, and errors in recording and reporting financial transactions. Given the significant amount of policy and procedures updating that is required, CANEX should take corrective measures to ensure that its policies and procedures are up-to-date and relevant.

It is important that this manual be updated as soon as possible. In addition to the existing four sections, a comprehensive loss prevention section should be developed and added to the manual. Since loss prevention is an integral part of risk management, the issues are dealt with in that section of this report.

Recommendation

The CANEX Policy and Procedures Manual should be updated as soon as possible. In addition to updating the manual's existing sections (i.e., Administration, Services, Operations, and Merchandising), a supplementary section covering loss prevention should be developed and added.

OPIs: MSP and PPTM

SMS Users' Manual

One of the primary concerns raised by CANEX store managers and staff was the absence of both a basic SMS users' manual and a formal SMS training program. While the SMS system is an important tool for store managers, who are required to adopt a new SMS report-based "morning routine," many expressed concern about the amount of unproductive time that is spent trying to understand the system's capabilities, operation, and dealing with technical issues. CANEX senior management has taken specific measures to strengthen SMS support—such as the establishment of an SMS Cell at HQ in Ottawa—including a help desk function. Given the multitude of concerns raised throughout this report in relation to the SMS system, the creation of a users' manual and an associated training program should be among CANEX's top priorities for SOP development and training.

Recommendation

An SMS users' manual and an associated training program should be developed and implemented.

OPIs: PPTM and NM SMS/IT Projects

A-FN-105

Of the forty-five chapters in A-FN-105, only eight have been updated within the past five years. All of the chapters specifically related to CANEX are out of date (e.g., Chapter 41 CANEX Outlets, Chapter 42 Retail Stores, Chapter 43 Grocery Stores, Chapter 44 Combination Stores, Chapter 51 Purchases—CANEX Retail Outlets and Central Billing, Chapter 52 Credit Sales, and Chapter 54 Lottery Tickets).

The changes in roles, responsibilities, and processes resulting from the 2005 CANEX reorganization and from the various accounting and managerial procedural changes that have been implemented to modernize business operations are not reflected in the applicable chapters. For example, Chapter 42 Retail Stores still reflects the requirement for retail outlets to maintain and control inventories using the retail accountability method. This method has been discontinued in favour of using the cost accountability method. Similarly, Chapter 43 Grocery Stores continues to reflect the requirement for ExpressMarts to maintain and control inventory using the retail accountability method. Chapter 51 Purchases—CANEX Retail Outlets and Central Billing does not reflect a new central billing process that was implemented in April 2009.

The maintenance and updating of A-FN-105 is the responsibility of DGPFSS/CFO. During the conduct of this audit, DGPFSS/CFO developed and implemented a two-year plan to update A-FN-105. Since CANEX's priority is to develop and implement critical SOPs and operational policies, DGPFSS/CFO intends to update the CANEX chapters of A-FN-105 once these SOPs and operational policies are in place.

The amount work required to update the CANEX Policy and Procedures Manual, the loss prevention policy guidance, and the development of several CANEX SOPs—when combined with the additional work required in the area of training and development—requires more than a single staff member’s efforts. CANEX senior management is aware that all policies and procedures require updating and has started with the higher-priority areas such as stocktaking, cash handling, and CAPI SOP development.

During the course of this audit, CANEX hired a training coordinator to assist the PPTM with the training and development workload, especially CANEX e-University development and management. While CANEX’s stated intention is to hire a policy and procedures coordinator, as of April 2010 no employment opportunity poster advertising such a position had been published.

Roles and Responsibilities of E&SSM

The responsibilities assigned to CANEX’s E&SSM may be too onerous for a single staff member to manage effectively and the current staffing strategy does not recognize the substantial subject matter expertise that is required for this role. Consequently, ||| and strategic level analyses are not being performed.

In June 2001, CANEX hired a National Manager, Loss Prevention (NMLP) who was tasked with the design and implementation of a formal loss prevention program. A subsequent strategic re-evaluation of the NMLP’s focus resulted in changes to the responsibilities assigned to this position. Currently, responsibility for loss prevention is part of the duties of the E&SSM. The position is currently being filled by a military member with the Military Occupation Structure Identification 00165 – Steward Non-Public Funds (NPF).

The E&SSM reports directly to the NMBDS and his primary duties are related to loss prevention, security, and environmental issues. In addition to these duties, the E&SSM has inherited duties related to concessions and construction projects in the Quebec region. Typically, NPF Stewards are not provided with the training and experience required to effectively manage security services, environmental issues, concessions contracts and construction project negotiations. It is estimated that approximately 80 percent of the E&SSM’s time is devoted to loss prevention and security-related duties, and the remaining 20 percent is devoted to duties related to environmental issues and the Quebec region.

The E&SSM is required to perform a security evaluation for each of CANEX's outlets at least once per year. This requirement translates into 42 store security evaluations each year. Currently, the E&SSM is solely responsible for performing all of the store evaluations. When these security evaluations are considered in concert with any environmental evaluations that must be performed, and additional duties in the Quebec region, the resulting travel schedule would become quite gruelling for a single individual. It was noted that, in an effort to save money, the E&SSM performs spot checks for all outlets on a specific base during visits for other reasons.

Reporting about Loss

Incidents of loss are not being consistently reported to CANEX HQ nor are they tracked, and neither store-specific nor corporate-wide trend analyses are being performed.

The E&SSM is currently stretched too thin. The sheer number of security and environmental evaluations that must be performed each year, not to mention any unanticipated issues that may arise, have resulted in important strategic-level analyses not being performed. Also, there is a risk that not all stores will be evaluated in each year. In addition, important security and loss prevention trend data (about incidents) are not being tracked on an ongoing basis due to, among other reasons, time constraints.

Recommendation

CANEX's senior management should re-evaluate this position, determine the exact role and function that are required, and develop an appropriate staffing strategy.

OPIs: V.P. CANEX and NMBDS

Risk Management

A risk management framework should be developed for CANEX to clearly demonstrate to its stakeholders that appropriate risk response strategies are in place.

Risk is an expression of the likelihood and impact of an event with potential to influence the achievement of an organization's objectives. Organizations that manage risk well are more likely to achieve their objectives. Risk management includes the identification of an organization's risk tolerance, the assessment and ranking of higher-level risks, the linking of risks with strategic objectives and corporate priorities, and the development of risk responses.

DGPFSS includes a section for CANEX as part of its strategic level risk assessment. The assessment summarizes, at a high level, the risks for CANEX Credit Plans, Retail Operations, Concessions, Group Plans, E-Retailing, and Environmental Issues. It also identifies potential impacts and provides assessments or rankings of both the impacts and likelihood for risk and opportunity management.

The analysis identified three specific areas related to risk management that require attention at the divisional level:

- An overarching RMF for CANEX;
- ||| and
- Tracking and trend analysis about incidents of loss.

Risk Management Framework

In its 2009-2010 Business Plan, CANEX assessed two dimensions of risk measurement:

- The magnitude of potential losses; and
- The probability of occurrence.

A number of risks (internal and external) were identified and mapped against these dimensions.

There are important risks that have not been formally recognized in CANEX's risk assessment framework such as:

- The risks of loss of merchandise as a result of employee theft;
- Risk of theft by external persons (e.g., delivery drivers, shoplifters and robbery, and merchandise return fraud);
- Risks of loss due to flooding, fire, power outages, etc.;
- Legislative and regulatory risks (e.g., non-compliance with taxation, tobacco, alcohol, environmental, and food safety laws and regulations);
- Supplier/supply-related risks;
- Workplace safety risks;
- Foreign currency risks; and
- Risk to CANEX's reputation/image.



While the risks identified by CANEX in its 2009-2010 Business Plan have been ranked according to potential loss and probability, the scale is not clearly defined and there is no associated discussion of the risks. The probability and potential losses have not been quantified in terms of percentages or dollars, the relative risk rankings have not been justified, and risk tolerance thresholds have not been explicitly identified.

Potential responses to the identified risks have not been articulated. For each risk, management has the following response options:

- Avoid the risk (e.g., cancel the activity);
- Transfer the risk (e.g., purchase insurance);
- Accept the risk (i.e., take no action); or
- Mitigate the risk (e.g., policies, procedures, training programs, financial controls, security measures, supplier agreements, workplace safety measures).

Many of these elements are already in place and simply need to be enhanced and/or brought together in a comprehensive integrated RMF that could then be easily incorporated into the DGPFSS corporate-level RMF.

The absence of a comprehensive RMF increases the risk of CANEX not recognizing all of the important risks and their potential impacts and, thus, not taking the appropriate measures to respond to these risks. Since risk is the expression of the likelihood and consequences of an event with potential to influence the achievement of an organization’s objectives, CANEX may be impeded from achieving its objectives. In addition, the RMF is a tool that would provide CANEX with the ability to clearly articulate its risk profile to its stakeholders. It would also demonstrate to these stakeholders that CANEX has taken measures to ensure that appropriate risk response strategies are in place.

Recommendation

A strategic risk assessment should be undertaken. This should include a comprehensive risk identification and review process, relative risk ranking (e.g., high, medium, and low), establishment of risk tolerance thresholds, and development of risk response strategies.
OPI: MSP

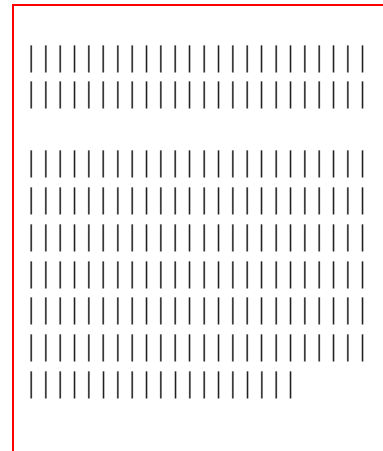
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The initial cost of the [redacted] and the installation costs are covered by CANEX HQ and only the monthly service charges are paid for by the individual CANEX outlets. In addition, any expenses related to the repair or replacement of [redacted] are paid for by HQ. As a control measure, the E&SSM reviews and signs all invoices related to the purchase of [redacted]



[redacted] Loss of merchandise results in lower gross profit (GP), which translates into fewer funds being made available for important morale and welfare (MW) programs.

Recommendation
Senior management should implement measures to ensure that store managers promptly report any problems [redacted]
OPIs: NMBDS and E&SSM

Tracking and Analysis of Incidents of Loss

Although many of the important elements exist, there is no overarching loss prevention policy guidance in place. While a Loss Prevention Incident Report (LPIR) is used, incident reporting to HQ by store managers is inconsistent, and trend analysis is not possible due to a lack of historical incident tracking.

The primary causes of merchandise inventory shrinkage are various forms of theft (by customers, employees, or suppliers), fraud, and environmental hazards such as fire, flooding, and power outages. Risk management and loss prevention are enterprise-wide activities that need to be strategically coordinated in conjunction with all other strategic activities. Ultimately, the reason for implementing a loss prevention program is to minimize merchandise inventory shrinkage and, thereby, maximize GP.

In 2001, CANEX’s NMLP was tasked with the design and implementation of a formal loss prevention program. These duties included the creation of a Loss Prevention Training Manual. In addition, CANEX developed a Zero Tolerance Policy that was to be read, signed and dated by each employee and a witness. A Monthly Loss Prevention Checklist was also created that was meant to be completed by store managers.

A draft version of a CANEX Loss Prevention Management Guide, dated July 2007, that had been forwarded to the NMBDS for review and approval, was reviewed.

As of May 2010, the guide had not been approved, published, or distributed. The E&SSM indicated that, other than the draft guide and the LPIR, there are no other formal loss prevention, environment, or security policies or SOPs in place.

The LPIR is an appropriate tool for documenting and reporting incidents of loss. It is in MS Excel format and includes detailed instructions on how to complete each field in the report. It also provides direction on where to forward the LPIR in case of an incident. However, there is no LPIR compiling mechanism or database used to track incidents or trends. In addition, CANEX has no way of knowing whether all incidents of loss are reported by the store managers. While CANEX has a zero tolerance policy in place for employees, there does not appear to be a clear policy outlining store managers' responsibility for reporting incidents to HQ. More specifically, the reporting threshold is not clear.

The E&SSM also provided a copy of a “store spot check and questions” template that is already being used to record observations in the field, and a random sample of completed spot check reports that are on file. The checklist is quite comprehensive and covers security, loss prevention, and safety issues. However, summary reports of this information are not compiled nor is any analysis conducted.

The absence of policy and procedural guidance on loss prevention has resulted in important information not being communicated from CANEX outlets to HQ. Consequently, CANEX has no clear record of historical information on incidents of loss compiled by any individual store nor on overall corporate trends.

Recommendation

CANEX senior management should ensure that a clear and up-to-date record of historical information on incidents of loss is compiled, and that individual store and corporate trend analyses are performed.

OPIs: NMBDS and E&SSM

Management Controls, Accountability and Stewardship

Certain elements of purchasing and inventory management, including supplier agreement negotiation and inventory discrepancy investigation, require attention.

Procurement of Merchandise for Resale

Management controls, accountability, and stewardship are assessed using a purchasing cycle approach. As is depicted in Figure 3, the cycle commences with the determination of merchandise needs, supplier selection, and supplier agreement negotiation. In the second phase, authorization to purchase merchandise is obtained and orders are placed. Phase three involves the receipt of merchandise and invoice processing, including obtaining invoice payment approval. The final phase is financial settlement which includes claiming available discounts.

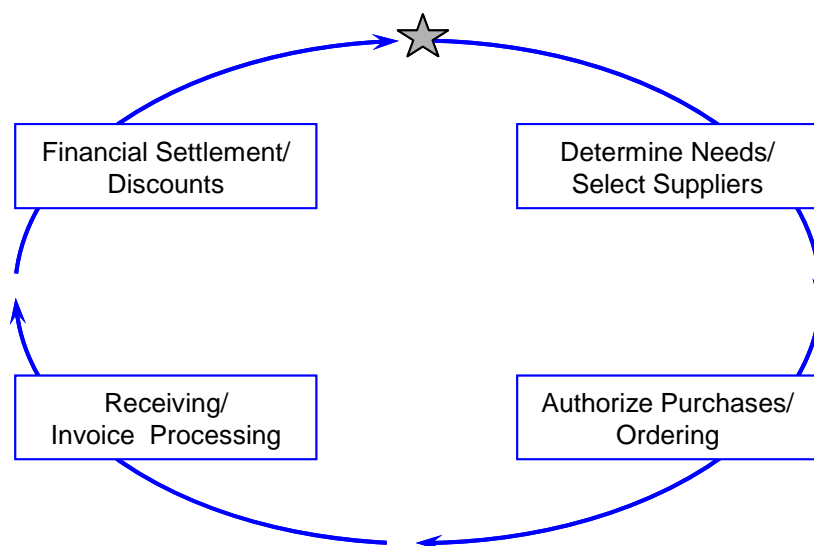


Figure 3. Flowchart of the Merchandise Purchasing Cycle. This diagram illustrates the four phases of the merchandise purchasing cycle.

Purchasing of merchandise for resale is divided into two distinct streams: (1) Centrally managed purchasing (national level at HQ); and (2) local-level purchasing by CANEX store managers.

At the national level purchases are the responsibility of CANEX category managers. Five category managers are responsible for specific product departments (e.g., Department 1 Soft Drinks/Candy/Confectionery). The category managers employ three primary methods in the central purchasing of merchandise:

- Distribution Purchase Orders (DPO);
- National Purchasing Programs; and
- Basic Replenishment Programs.

At the local level, if new suppliers or products are required, store managers must send all new supplier agreements to the category managers for approval before the supplier can be created in SMS. Upon receipt of local supplier agreements, the category managers review the terms and conditions and also fulfill a challenge function by questioning the store manager.

Overall, CANEX's purchasing process is assessed to be functioning effectively. There are, however, a few areas that need to be addressed.

Supplier Agreements

The supplier agreement negotiating and tracking process needs to be strengthened.

The terms of most supplier agreements are re-negotiated annually. CANEX's category managers negotiate prices, freight terms, and all other contract terms with national suppliers. The merchandising manager reviews the terms, including delivery, discounts, etc., and compares to the terms and conditions of prior agreements.

The category managers and, in some cases, the merchandising manager, meet with national suppliers to negotiate or re-negotiate supply agreements. For products supplied by national suppliers but in a local market distribution model (e.g., Coca Cola, Pepsi, Frito Lay) the category managers negotiate overarching contracts and the Store Managers deal with the suppliers' territory managers.

An initial sample of supplier agreements for 17 national-level suppliers and 11 local suppliers was reviewed. As depicted in Table 2, a total of 28 supplier agreements were reviewed.

Description	Initial Sample	Extended Sample	Total Sample
Total no. of agreements reviewed	28	8 *	36
No supplier signature	2	2	4
No CANEX signature	6	2	8

Table 2. Supplier Agreement Review Summary. *Note that for the extended samples, the audit requested a sample of 19 supplier agreements, but CANEX provided only 8 agreements.

During the review of the initial sample of supplier agreements, it was noted that certain agreements had been signed after the date upon which the agreements had been requested for review (i.e., 9 June 2009). Since the existence of these agreements prior to 9 June 2009 could not be verified, the sample was expanded and a second request was made for supplier agreements. An additional 19 supplier agreements were requested. CANEX was only able to provide copies of eight of the requested agreements. As shown in Table 2, 12 of the 36 agreements that were reviewed were not signed by either the supplier or a CANEX category manager, or both.

CANEX also provided a copy of a supplier agreement master list that is used to track supplier information, including supply agreement terms. The information provided in the supplier agreements was compared against the information contained in the supplier agreement master list. It was observed that for 58 percent of the agreements reviewed, the information had not been updated in the supplier agreement master list. During the conduct of this audit, CANEX senior management stated its intention to strengthen the supplier agreement negotiation and tracking process by ensuring that, on a quarterly basis, the category managers are provided with a list of supplier agreements that are due for re-negotiation. These lists will be derived from the supplier agreement master list.

Given the large number of supplier agreements that could not be provided as well as those that have not been signed by either the supplier or a CANEX Category Manager, or both, CANEX is exposed to avoidable risks. Not having in place legally binding agreements with suppliers increases the risk of CANEX not obtaining the best prices, discounts and volume rebates (i.e., value for money), and CANEX may not be adequately protected in case of disputes with suppliers over contract terms. Since CANEX intends to provide category managers with lists of supplier agreements that need to be re-negotiated, it is critically important that the supplier agreement master list be kept up to date at all times.

Recommendation

The supplier agreement negotiation and tracking process should be strengthened. Supplier contracts and agreements should be kept up to date. The Master List of Suppliers should also be kept up to date.

OPI: DMM

Receiving Function and Supporting Documentation

Assurance cannot be provided that either the receivers or the invoice clerks consistently match purchase orders (PO) with packing slips/invoices prior to sending these packing slips/invoices to the NPF accounting offices.

Chapter 21 of A-FN-105 and the SMS Shipper/Receiver SOP both require that POs and SMS Receiving Reports are matched with packing slips/invoices. Following approval by the store managers, POs, Receiving Reports, and supplier invoices are to be forwarded to the local NPF accounting office. The local accounting office is to record the information related to the purchase in the accounting system, and the supporting documents are to be scanned and posted on the document storage website.

A sample of 67 HQ-generated purchases was reviewed. Of these transactions, 34 percent did not have DPOs included as part of the supporting documentation that was downloaded from the document storage website, and 21 percent did not include a receiving report. Since it is not possible to verify whether the appropriate documents were forwarded to the local accounting offices, this audit cannot provide assurance that the merchandise was actually entered in the SMS system, or that it was checked for damage and counted by CANEX receiving staff.



A sample of 36 local purchases was also reviewed. Of these transactions, 18 required a CANEX local purchase order (CPO). For 72 percent of these transactions, a CPO was not included as part of the package of supporting documentation that was downloaded from the document storage website, and 68 percent did not include a Receiving Report. Therefore, this audit cannot provide assurance that either the receiver or the invoice clerk is matching POs with packing slips and/or invoices prior to sending them to the local NPF accounting office.

The following risks are increased when the ordering documents are not available to the receiver and/or invoice clerk:

- Not receiving merchandise that was ordered;
- Receiving merchandise that was not ordered;
- Receiving the wrong merchandise (i.e., ordered “A” but received “B”);
- Possible increases in spoilage and mark-downs resulting in decreases in GP; and
- Discrepancies between merchandise that is ordered, and invoiced quantities and/or prices.

Other risks include the effects of inefficient operations due to having to return goods for credit or replacement, not having the required merchandise available for sale when needed, and paying more for merchandise than was intended at the time of ordering, thereby potentially reducing the GP.

Recommendation

CANEX FOMs should ensure that POs and Receiving Reports are included as part of the supporting documentation that is sent to the local NPF Accounting Offices.

OPI: FOMs

Approval of Invoices for Payment

There are instances where invoices were processed and paid without the approving signature and where the signatures authorizing payment are illegible and the signatory is not easily identifiable.

A sample of 103 transactions was reviewed to ensure that invoices were properly approved prior to payment. Of these transactions, four were not properly approved and in 13 instances related to local purchases it was not possible to determine who signed the invoice and approved the payment. In total, it was not possible to verify that 17 of the sampled invoices were properly approved prior to payment.

It is also important to note that, in 2005, the DGPFS' CFO directed the NPF Accounting Offices to cease using specimen signature cards to verify signatures. The absence of proper approvals prior to payment, and the inability to verify approval accountability due to illegible signatures, increase the risk of fraud and misuse of NPF.



Recommendation

The CANEX FOMs should ensure that payment approval accountability is enforced by requiring: a) signature; b) date; and c) the name and title of the signatory is printed below the signature.

OPI: FOMs

Inventory Management

Management controls, accountability and stewardship were also assessed by reviewing CANEX's core inventory management processes and functions. As shown in Figure 4, the review focused on inventory valuation, merchandise transfers, stocktaking, and inventory shrinkage.

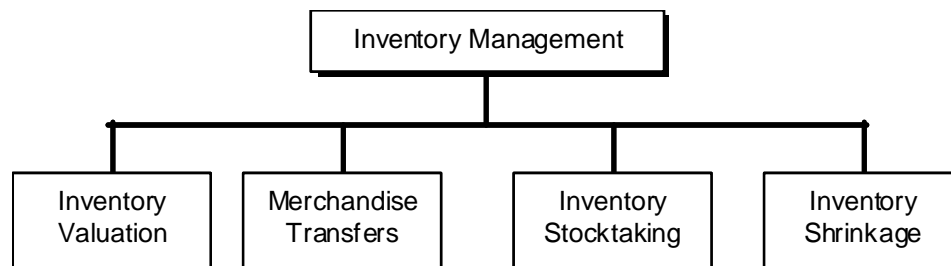


Figure 4. The Core Inventory Management Processes and Functions. The four core inventory management processes and functions.

It is important to note that these processes are not separate and distinct elements, but are integrally linked. Two areas that require attention, namely, inventory valuation and stocktaking are discussed in this section.

Inventory Valuation

Due to the mentioned problems encountered during the analysis, this audit cannot provide assurance that inventory values are stated correctly in CANEX's SMS system.

To verify the accuracy of inventory values, two elements needed to be assessed: (1) the average costs of items; and (2) quantities on hand. The validity of the average cost is important since average cost times quantity determines inventory value. The analysis also focused on CANEX's stocktaking process that is used to determine quantities on hand.

In 1996, CANEX established a project to install Point of Sale (POS) technology in its outlets. The plan was to fully implement the technology over a period of two years. The technology was considered integral to achieving better inventory controls and improved management information and, hence, improved profitability and performance. CANEX purchased and customized the SMS system for its outlets with additional features for inventory management. However, the SMS system was only used as a "glorified cash register" until 2008. CANEX senior management noted that, while the POS system has been in use for the past 14 years, it has only been used for inventory management purposes since 2008. In 2007, CANEX established the National Manager, SMS/IT Projects position, whose mandate is to modernize, standardize and develop the SMS system from a POS/cashiers' tool to a national inventory management system.

The opening of a new retail outlet during the conduct of this audit represented an excellent opportunity to test various aspects of the CANEX procurement and inventory management processes and procedures. Unfortunately, as the analysis progressed a number of problems were encountered that limited the value of the exercise. The new retail outlet started purchasing and receiving merchandise in January 2009. It opened for business on 4 March 2009. Therefore, an SMS IMR for January showing opening inventory levels of zero for all departments should have been available for review. This report should have included the January purchases and the resulting ending inventory values. Inventory values for the purchases made in January could then have been tracked and the tracking of specific items could then have been extended to include subsequent months.

The SMS system for the new store was not operational, however, during the months of January and February 2009. Consequently, the IMR for those months were not useful. Due to the extent of these and other problems encountered with the SMS reports for the new retail store, the IMR sample was extended to include reports from a second CANEX retail outlet to determine whether the problems observed are a local issue or if they are systemic. Similar problems were encountered during the review of SMS IMR obtained from the second retail outlet. Consequently, analysis of the IMR from both locations suggests that some of the SMS system data integrity issues are systemic.

Even though the SMS system has been used by CANEX since 1996, the desired results of better inventory management and controls continue to be somewhat elusive. The category managers stated that the primary method being used to manage inventory is continuous monitoring of merchandise sales and GP figures. CANEX management is taking action to improve this situation. In the context of an imperative for continuous improvement, CANEX has established an SMS cell at HQ that includes a help desk function.

Average Cost of Merchandise Inventory. Another element reviewed was average cost. The objective was to verify the accuracy of average costs for selected items tracked by the SMS system. Over the course of the audit a number of standard SMS reports that are used by management were requested for review; however, none of these reports provided sufficient information to facilitate the verification of the accuracy of average costs. Consequently, assurance cannot be provided as to the accuracy of average cost and inventory values in the SMS system. Erroneous average cost figures in the SMS system will directly affect financial statements. This, in turn, could have an adverse effect on decision making.

Recommendation

CANEX senior management should ensure that the information provided in the SMS system related to the value of inventory is complete and accurate.

OPI: NM SMS/IT Projects



Stocktaking

CANEX uses the SMS system for perpetual inventory tracking. Hence, the purpose of physical stocktaking is not only to count inventory but also to ensure that inventory levels in the SMS system are consistent with physical counts. The physical inventory counts are conducted by Western Inventory Systems International (WIS) and local NPF accounting staff is responsible for checking the accuracy rates of inventory counts performed by WIS employees. WIS' accuracy rates are measured by the use of "red checks," which are third-level verifications conducted by the NPF accounting staff. Stocktaking is conducted twice per year (March-April and October-November) for all CANEX outlets. Currently, the stocktaking process, including planning and monitoring, is being led by the MSP. The MSP tracks stocktaking results and analyzes WIS performance and costs. Overall, the stocktaking process employed by CANEX is adequate to meet its objectives. However, there are some compliance issues that should be addressed.

Investigation of Inventory Discrepancies. Inventory discrepancies of \$1,000 or more or greater than 100 units are not being consistently investigated, as CANEX's stocktaking SOP requires.

In March 2009, 29 stores submitted WIS-SMS post-stocktaking variance reports to CANEX HQ. A review of these reports indicates that variances over \$1,000 are not being consistently investigated. Following the October 2009 stocktaking, 38 stores submitted WIS-SMS variance reports. A review of these reports revealed that there were 35 instances where variances over \$1,000 occurred, and that only one of them was explained. Identified discrepancies are not being investigated. CANEX senior management noted that \$1,000 may not be the appropriate threshold for investigation, and that variances in gross profit are currently used to identify inventory discrepancies. It was also noted during the audit that the threshold of 100 units was never mentioned, nor is there any evidence of such discrepancies being investigated.

Inventory discrepancies resulting from the loss of merchandise, for whatever reason, that are left un-investigated could result in lower GP and, therefore, fewer funds available to support important MW programs. Also, discrepancies resulting from systematic problems with, for example, the SMS system that are overlooked will result in the problems not being rectified. Consequently, since SMS data is imported to the corporate accounting system, financial reporting could also be adversely affected.

Recommendation

CANEX HQ should review the \$1,000 and 100-piece thresholds for variance investigation, and either confirm their continued relevance or establish relevant thresholds. Once relevant thresholds have been set, senior management should ensure that variance investigations are conducted.

OPI: MSP



NPF “Red Checks” of Sealed Boxes. The stocktaking SOP requires that CANEX employees perform a pre-inventory count on all boxed stock and attach scannable product labels to the facing side on each box. Employees are to ensure the quantity is clearly recorded on each label with blue pen, and the boxes are to be sealed after counting. Consequently, WIS staff counts this inventory by using the product labels and quantities indicated on the exterior of the boxes. It is not clear if NPF accounting staff opens a sample of these boxes while performing the red checks to verify their contents. Since inventory quantities inside the boxes are not verified by WIS staff, an opportunity exists to conceal the fact that there is missing inventory.

Recommendation

NPF Accounting staff should open and verify the contents of a sample of sealed boxes as part of their “red checks” during stocktaking.

OPI: MSP



Annex A—Management Action Plan

Governance

CRS Recommendation

1. **CANEX Standard Operating Procedures.** CANEX should ensure that its SOPs are kept up to date and relevant.

Management Action

Agree. Current policy and procedures manuals (Operational, Merchandising & Administration) require updating. Core business processes are to be modernized first. The policy and procedures are being distributed/communicated on the CFPSA Website Employee Zone, via CANEX eUniversity and through physical copies.

As of July 2010, modernized policy and procedures have been developed and are in use in the following priority areas: Shipping/Receiving, Stocktaking/Inventory Control, & Cost Accounting/Perpetual Inventory.

Policies and procedures that are currently in development include Clerk/Cashier, Cash Handling and SMS. Other outstanding policies and procedures requiring updating to be prioritized for FY 2011/12.

OPIs: MSP and PPTM

Target Date: Clerk/Cash, Cash Handling, October 2010; SMS, 1 April 2011

CRS Recommendation

2. **CANEX Policies and Procedures Manual.** The CANEX Policy and Procedures Manual should be updated as soon as possible. In addition to updating the existing sections of the Manual (i.e., Administration, Services, Operations, Merchandising), a supplementary section covering loss prevention should be developed and added.

Management Action

Response for serial 1 applies.

OPIs: MSP and PPTM

Target Date: 1 April 2011

CRS Recommendation

3. **SMS Users' Manual.** An SMS users' manual and an associated training program should be developed and implemented.

Management Action

Response for serial 1 applies.

OPIs: PPTM and NM SMS/IT Projects

Target Date: 1 April 2011

CRS Recommendation

4. **Role and Responsibilities of the E&SSM.** CANEX's senior management should re-evaluate this position, determine the exact role and function that are required, and develop an appropriate staffing strategy.

Management Action

Agreed. Will work with the Military Occupation Code (MOC) manager regarding selection for the position and the MOC fit. Upfront training and tools will be provided to support the competency levels required. CANEX to review and create a job description for the E&SSM position and will develop the appropriate tools and training for this position.

OPIs: V.P. CANEX and NMBDS

Target Date: 1 April 2011

Risk Management**CRS Recommendation**

5. **Risk Management Framework.** A strategic risk assessment should be undertaken. This should include a comprehensive risk identification and review process, relative risk ranking (e.g., high, medium, and low), establishment of risk tolerance thresholds, and development of risk response strategies.

Management Action

Agreed. CANEX's strategic risk assessment will be incorporated into the DGPFSS Risk Management Framework. The CANEX portion of the framework is planned to be in use for the start of FY 2011/12.

OPI: MSP

Target Date: 1 April 2011



CRS Recommendation

6. ||| Senior management should implement measures to ensure that store managers promptly report any problems |||

Management Action

Agreed. |||

OPIs: NMBDS and E&SSM

Target Date: ||| 1 April 2011

CRS Recommendation

7. **Tracking and Analysis of Incidents of Loss.** CANEX senior management should ensure that a clear and up-to-date record of historical information on incidents of loss is compiled, and that individual store and corporate trend analyses are performed.

Management Action

Disagree. A reporting, tracking and analysis process is in place and reviewed monthly/quarterly at CANEX management meetings. To improve this process CANEX will define the thresholds for reporting and the tracking and analytical tools to be utilized.

OPIs: NMBDS and E&SSM

Target Date: 1 April 2011

Management Controls, Accountability and Stewardship

CRS Recommendation

8. **Supplier Agreements.** The supplier agreement negotiation and tracking process should be strengthened. Supplier contracts and agreements should be kept up to date. The Master List of Suppliers should also be kept up to date.

Management Action

Agree. CANEX identified this gap and as a result is developing an automated tracking system that will commence with flagging supplier agreements that will expire in the next quarter. This initiative is linked to our data cleanup cycle and the creation of a new items management system. Additional information about field requirements has been identified to facilitate identification of national versus local vendors, local OPIs at base/wing level, etc. Completion of the next data cleanup cycle, in the third quarter of this year, will support implementation of the new data base for 1 April 2011.

OPI: DMM

Target Date: 1 April 2011

CRS Recommendation

9. **Receiving Function and Supporting Documentation.** CANEX FOMs should ensure that POs and Receiving Reports are included as part of the supporting documentation that is sent to the local NPF Accounting Offices.

Management Action

Agree. National managers have provided direction to stores. This point has been incorporated in the Store Evaluation Report checklist. The CANEX Management Accountant has been directed to follow up with local accounting offices on a periodic basis and report as part of the Quarterly Management Meetings.

OPI: FOMs

Target Date: Completed



CRS Recommendation

10. Approval of Invoices for Payment. The CANEX FOMs should ensure that payment approval accountability is enforced by requiring: a) signature; b) date; and c) the name and title of the signatory is printed below the signature.

Management Action

Agree. Response for serial 9 applies. In addition, an appropriate stamp has been designed and has been provided to all stores.

OPI: FOMs

Target Date: Completed

CRS Recommendation

11. Inventory Valuation. CANEX senior management should ensure that the information provided in the SMS system related to the value of inventory is complete and accurate.

Management Action

Agree in principle. Reports will be reviewed for accuracy and problems will be rectified.

OPI: NM SMS/IT Projects

Target Date: 1 April 2011

CRS Recommendation

12. Investigation of Inventory Discrepancies. CANEX HQ should review the \$1,000 and 100-piece thresholds for variance investigation, and either confirm their continued relevance or establish relevant thresholds. Once relevant thresholds have been set, senior management should ensure that variance investigations are conducted.

Management Action

Agreed. Existing thresholds have been reviewed and deemed to be relevant. An automated reporting process has been established with WIS and the stocktaking SOPs have been updated. As of the September 2010 stocktaking, store managers must review an exception report, which highlights threshold discrepancies, prior to completing the data upload. Variances that exceed the thresholds must be reported to HQ who will ensure that store managers provide a summary of the results of the investigation.

OPI: MSP

Target Date: Completed



CRS Recommendation

13. **NPF Red Checks of Sealed Boxes.** NPF Accounting staff should open and verify the contents of a sample of sealed boxes as part of the “red checks” during stocktaking.

Management Action

Agreed. Confirmed that red checks procedures do not explicitly address the recommendation. CANEX has emphasized this requirement with NPF Accounting and directed that the practice be followed as part of all future stocktaking sessions.

OPI: MSP

Target Date: Completed



Annex B—Audit Criteria

Objective

1. Ensure that a proper governance structure is in place.

Criteria

- Appropriate monitoring and reporting tools and procedures are in place to provide senior management with timely, accurate, and relevant information for decision-making purposes;
- Policies and procedures are up-to-date and consistent; and
- Roles and responsibilities are clear, communicated, understood, and adequate to provide effective oversight.

Objective

2. Ensure that an appropriate risk management framework is in place and that risks are effectively managed.

Criteria

- Identifiable risks are recognized and understood;
- CANEX's risk assessment is based on likelihood and consequences;
- Risks are quantified and risk impact thresholds have been established; and
- Appropriate risk response strategies have been developed.

Objective

3. Functions within the purchasing cycle are conducted in accordance with the relevant policies, procedures and best practices.

Criteria

- There is a determination of needs process in place and it is working effectively;
- The supplier selection and negotiation process is adequate and working effectively;
- Purchases are properly authorized before orders are placed and the ordering process is working effectively;
- The process in place for receiving merchandise is adequate and working effectively; and
- Payments are made only for merchandise that has been ordered and received, are properly authorized, in the correct amounts, are recorded accurately, and are timely.



Objective

4. Functions within the merchandise inventory management cycle are conducted in accordance with the relevant policies, procedures, Generally Accepted Accounting Principles and best practices.

Criteria

- Merchandise transfers are conducted in accordance with policies and procedures;
- Merchandise inventory is properly valued;
- Stocktaking is performed in accordance with policies and procedures; and
- There is a process in place to minimize inventory shrinkage.