

White Paper



Impacts of Sarbanes Oxley Requirements as Applied to Incentive Program Management: Commentary by George Kriza, Chairman & Founder, MTCPerformance



Note: This document was prepared with substantial reference to a document published by Dan Swanson of Tripwire, Inc. Dan Swanson is a credentialed audit consultant. His source document is available at: <http://www.findwhitepapers.com/index.php> as document 440_Tripwire Keeping up your SOX compliance white paper. Any similarities in my text and his, credit should go to Mr. Swanson and the source document, even if it is not rigorously footnoted. George Kriza is not personally a Sarbanes Oxley expert, so this material below draws primarily on his expertise in designing and deploying both incentive programs and incentive management software.

Introduction

The last several years have seen a tremendous increase in governmental regulatory legislation that profoundly affected the way corporations, and particularly public corporations must manage their businesses. The Sarbanes Oxley legislation is of particular interest to those corporations operating in an environment where sales and performance based incentive programs are a regular part of the business landscape.

The overarching theme of this legislation is that each public corporation's published financial statements must be solidly grounded in rigorous process control and accurate reporting. This process control extends to any and all areas that can substantively impact the financial statement. It includes extensive impacts across all business systems, including financial reporting, policy governance, business ethics, audit management (including new rigor in sign off authority), internal operational controls and more. Ultimately, the company's valuation is based on its financial health, and investors in its stock look at P/E ratios based on these statements. Potentially millions of dollars of valuation are at stake.

Each business process must have accountability and be auditable. As such, each process must be designed, trackable and validated for continuous compliance with SOX standards.

It is certainly true that a manufacturer's (or software publisher's) marketing and promotional dollars comprise a substantial portion of the enterprise's overall budget. Such programs are typically divided into consumer facing and channel facing categories. Consumer facing programs include brand, rebate, national promotion, co-op advertising and other related programs. Channel programs include market development funds, volume incentive rebates, and channel incentive programs, among others.

Likely, most of these programs are viewed as defined budgetary line items with defined outcomes, but there are many areas where the oversight of these funds, particularly channel funds, require substantial management process in order to comply with SOX and minimize risk and unintended consequences that have substantive and unexpected impacts on the corporate balance sheet. Let's take some time to review areas of channel incentive programs that might induce exposure to the corporate balance sheet.

Channel Incentive Programs Compliance Considerations

We'll start with a list of possible areas of risk and process management and then look at them individually:

- Program Creation Management, Program Design
- Effect on Employee Compensation
- Side Deals
- Chaotic Space
- Reward Calculation Methodology
- Assurance of Proper Application of Calculation Methodology
- Program Reward Disbursement Management
- Proper Tax Handling
- Exception Management
- Validation of Qualifying Error! Contact not defined.
- Capping Maximum Payouts
- Terms and Conditions Construction
- Regulatory Reporting Compliance
- International Regulatory Compliance and Reporting
- Internal Reallocation of Funds for a Non Intended Purpose

Likely there are several more. Let's begin our consideration of the risk and process management issues:

Program Creation Management, Program Design

There are several considerations in this category. First, is there a global policy inside your organization as to what constitutes a permitted and non-permitted promotion? This involves a comprehensive definition of promotion types and recognition of whether they are legitimate or illegitimate according to ethics or law. Also, are they consistent with your existing business practice?

Second, analyze what business purpose each promotion type serves, driving for clarity as to what kind of sales behavior modification it will engender. This is important for a number of reasons, most significantly is the impact on inventory position, as well as gross margin at POS. Will the sales rep trade margin dollars for the company for spiff dollars? There are numerous considerations in program design, often with unintended outcomes. Significant thought should go into all aspects of program structure.

Effect on Employee Compensation

For purposes of total structure of sales compensation, it is extremely useful to understand how base pay, variable pay, and indirect incentive pay contribute to the compensation equation. Useful for cost reduction and employee retention, this view is also vital to understand the way funds flow to the program participant and how they will meet the tax burden from their additional cash and non-cash earnings. In the absence of a structured solution, year end may have significant tax consequences for participants.

Side Deals

It is a well known fact, and has on occasion been the subject of unfortunate scandal, that marketing, merchandising and or sales management has often compromised their fiduciary interest by either allowing or promoting programs that were not in the best interest of their employer, or even taken money under the table to promote certain

products. In certain cases, these individuals were high ranking managers who abused significant authority to their own ends. There is a possibility that collusion between manufacturers internal managers, and even between internal managers and channel member managers could exist, particularly where there is no formal system in place and visibility and documentation of business practice.

Chaotic Space

In many organizations, there is no structured system to manage promotional channel programs. Programs may be conceived and launched serendipitously. Even if some structure exists, no mechanism is in place to track programs in various stages of design and deployment. There may be no visibility as to whether they have been properly fulfilled.

The sales and marketing department may be on different pages, and the executive team may not be aware what either are doing. Chaotic space is more pervasive than most executives fully understand, and it gives rise to and facilitates many of the problems discussed in this document.

A paper based approval system is better than pure "chaotic space". Nevertheless, it still allows for misfiling, skipping procedural steps, and miscommunication or lost paperwork. While better than pure chaotic space, there is still substantial opportunity for modernization and management.

Reward Calculation Methodology, Assurance of Proper Application of Calculation Methodology

Approved reward contests may involve structures ranging from simple to complex. When tiers, bundles, attach rates, lotteries and other forms are created and combined, the methods of calculation must not only be precisely constructed, but precisely communicated to the sponsors and all stakeholders. Imagine, if you will that someone thought they were creating a prize pool that amounted to \$25,000 but in fact calculated out to \$250,000. What is the impact on budget, goodwill, and who owns the liability for the delta in payout? Who is making the decision on which calculation method will apply? Will the situation become contentious with the program sponsor or the participant or participant group who is gaining or losing the value of the prize?

If programs are competitive in nature, what rules are in place for tie breaking, particularly when expensive prizes are at stake? How will returns impact the receipt of prizes or cash awards? In a sweepstakes, is the selection of winners handled by a truly unbiased, independent and random process? These scenarios, and many more, need managerial consideration.

Program Reward Disbursement Management

Potentially, an individual qualifies for a prize in a promotion, and then never receives it, or receives something different than what they thought they were getting. Who manages the process of program fulfillment? With many promotions yielding hundreds or even thousands of prizes being transacted each year, the amount of follow-up and management is substantial.

What happens if the sponsoring company defaults or reneges on giving out the prizes? If you are a channel member whose employee wins a prize they never receive, who is responsible? Do your terms and conditions cover this situation? If not, you may be left holding the bag for expensive rewards.

Proper Tax Handling

All incentive programs must be properly handled for tax considerations. First, if you don't know what your employee has earned, both individually and cumulatively across all promotions, you can't possibly be in a position of knowing whether the tax considerations are being properly handled. Are all the filings done? Are they done properly? Is the data accurate? Significant tax penalties are regularly assessed by the IRS for improper tax filings.

Do the winners have funds available to pay the taxes? What if they don't? Will the sponsor company be required to implement pre-emptive withholding? What is the proper tax rate? Is the employer responsible to adjust the withholding rate based on non-employee income?

Exception Management

In any major program, there are hundreds to thousands of exceptions made for various reasons. While the exceptions always seem rational and prudent at the time they are implemented, will anyone remember what they did and why months and years later? Is there a documented audit trail of the exceptions? Is there a written policy?

Validation of Qualifying

All sales contests are based on documented sales. What is the method of documentation of sales? Is there a sales out report that is fully auditable? If not, is there an invoice trail, and serial number audit? What about the date range for qualifying invoice dates? What if I sell a product in June for a \$50 spiff, but it ships in July when a \$10 spiff is in place? "Why is that my fault" a participant might say. So there is both a validation issue and a policy issue that needs to be completely clear.

Capping or Managing Maximum Payouts

Various contests can involve extremely large amounts of budget dollars. A manufacturer or other sponsoring entity may wish to limit their exposure. From their point of view, it's possible to have too much success. Is there a mechanism in place to allow the sponsor to control its maximum exposure in the program. Is it properly implemented? And most importantly, what happens if for some reason, the system doesn't work as expected. Again, there is the possibility of very large financial liability. Systemic safeguards must be considered.

Terms and Conditions Construction

Well constructed terms and conditions statements can go a long way toward alleviating financial liability. Having considered the issues illuminated in this document, and others, rigorous T's & C's may be constructed to protect all parties from unfulfilled expectations and financial liabilities.

Regulatory Practice and Reporting Compliance

A qualified attorney or law firm and CPA retained by your firm should always be consulted to ensure that there is proper awareness of regulatory issues. In the US in recent months and years there has been a flood of regulatory issues that have surfaced. Some to be considered are: Anti Money Laundering, Patriot Act, Escheat / Abandoned Property Law, Consumer Protection Law, Contract Law and Sweepstakes Law. Each of these areas may require different areas of legal specialization. Failure to understand and properly apply the legal requirements involved can end up in years of retroactive penalties and liabilities. Ignorance of the law is never an excuse.

International Regulatory Compliance and Reporting

Basically the same as the above section, with the proviso that it cannot be assumed that other countries legal and regulatory system matches the US in any way, so the law firm and CPA's must know the country or countries in question. Additionally, national internal law and international commerce law may have different requirements.

Internal Reallocation of Funds for a Non Intended Purpose

Sponsor companies allocate substantial funds to underwrite incentive programs. If these funds are tendered to a channel organization to disburse to its employees on their behalf, and for various reasons, including employee termination, the funds don't reach the intended employee, some organizations or individuals may choose to redirect these funds to another purpose. Is this purpose approved by the sponsor company? Is it properly internally approved by top management? If not, is this now a slush fund that has created a hidden liability?

Summary

Diligent consideration of the above issues will go a long way towards improving Sarbanes Oxley compliance. The task is substantial, however, and needs to be considered by the executive team, the finance group, sales and marketing teams, IT and legal.

Implementation of control systems to manage these issues likely requires the investment of substantial planning time, as well as development of IT systems to produce coherent management of the entire incentive landscape. Alternatively, an enterprise level software solution might be found in the outsource community after due diligence. Companies such as Oracle, SAP, or MTCPerformance may offer solutions with varying degrees of comprehensiveness and focus.

While determining the solution and management process to be applied, it should not be lost on the reader that the purpose of these incentive programs fulfills a mission of great value to both the manufacturer and the reseller; that of educating, focusing and driving desired sales behaviors that contribute to increased total revenues, increased sales of associated products, drive toward greater gross margin, and more rapid and balanced inventory turnover.

About the Author

George Kriza is Chairman and Founder of MTCPerformance, an INC500, VAR Business 500, Crain's Fast Fifty incentive company located in Schaumburg IL. Mr. Kriza's career began in retail, where he learned first hand about the inner workings of retail operations. He followed this with many years of representing premier manufacturers such as Sony, Panasonic, Apple Computer and many others in sales and sales management capacities, to their channel members. He has called on virtually every major channel of retail trade, from the smallest mom and pop retailers to the largest national chains. Mr. Kriza earned his first spiff at 21 and designed his first spiff program at age 25, which was successfully deployed. For the last 14 years, Mr. Kriza has operated a successful channel incentive marketing firm, MTCPerformance, and directly participated in designing state of the art Business Process Management software systems for incentive program management.

About MTCPerformance™

MTCPerformance is the proven leader in software solutions for managing incentive programs that work by rewarding success. Its proprietary software-as-a-service approach provides innovative companies and their leveraged channel partners with a unique ability to highlight and accelerate the behavior they most value: increased

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revenues. The 14-year-old company is the creator and sole distributor of SpiffCENTRAL™ Vendor Manager and SpiffCENTRAL™ Channel Manager (patents pending), a collection of online spiff program management tools and databases customized for resellers, distributors, manufacturers and software publishers.

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