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When Channel Incentives Backfire
Strategies to help reduce Gray Market risks and improve profitability

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Executive summary

The figures are staggering. Channel incentives[1]—designed to boost sales by increasing loyalty and motivating channel partners[2] to sell products—are vulnerable to abuse which **may cost high tech companies an estimated $1.4 billion in lost profits each year[3].** In addition to this lost profit, the abuse of channel incentives helps fuel the high tech gray market. These are two key findings of research conducted by Deloitte and the Alliance for Gray Market and Counterfeit Abatement (AGMA®).

For technology companies, channel incentive abuse can translate into all manner of ills—from payment of unearned incentives, profit margin erosion, service and warranty abuse, and disruption of distribution channel environments, to an unlevel playing field across channel partners, negative impact to a brand, increased presence of counterfeit products[4] in market, and reduced customer satisfaction.

To better understand the current state of the industry's vulnerabilities to these issues and identify potential solutions, Deloitte and AGMA conducted a survey and a series of executive interviews with leading technology companies. The research found that channel incentive abuse may be a much larger problem than previously believed. **While respondents estimated that incentive abuse may affect up to 25 percent of all channel sales and result in significant lost profits, they also stated that it often goes largely undetected due to a lack of active program management and inadequate internal controls related to channel incentives.**

Based on Deloitte's experience serving many of the industry's top technology companies[5] and its knowledge of channel incentive management programs, as well as the first-hand experience of AGMA members, this report seeks to provide insight into successful strategies that can help companies detect, prevent, and reduce the gray market problem by limiting one of its sources—abuse of channel incentives.

"Channel incentive programs contribute to the success of many businesses that sell products via indirect channel models. However, if they are not effectively managed, these same incentive programs can create opportunities for gray market activity and other behavior that erodes profitability. Therefore, effective planning, execution, and management of channel incentive programs is needed to ensure the success of brand owners and channel partners alike."

—Ram Manchi, AGMA President

Clearly, channel partners are tremendously valuable to many technology companies—generating more than 75 percent of their revenue, according to a quarter of survey respondents. Channel incentive programs are created to support a company's sales objectives. However, the risks and rewards introduced by incentive programs must be balanced by creating consistent processes to administer, monitor and verify compliance, while enforcing protocols when dealing with identified non-compliance.

Strong channel incentive management programs may significantly reduce exposure to the gray market and capture billions[3] in what might otherwise be lost profit. Effective channel management programs enable companies to gain greater visibility into cross-functional incentive programs, and establish globally consistent policies through increased interaction with business and channel partners. Not only can these efforts reduce the number of gray market products in the market, but they can facilitate a better functioning distribution channel environment, reduce costs, and ultimately create stronger, more profitable brands.

The channel incentive abuse problem

It is a case of unintended consequences. In an effort to boost sales by increasing loyalty and motivating channel partners to sell products, technology companies around the world commonly use incentives—such as end-user pricing, volume incentive rebates, product promotions, and authorized channel partner program discounts. However, the unfortunate reality is that these same programs may actually **cost high tech companies an estimated $1.4 billion in lost profits each year[3],** according to research conducted by Deloitte and AGMA®.

This is because there appears to be a direct link between channel incentive abuse and the high tech gray market. However, reduced profitability is only the tip of the iceberg, since abused incentives appear to fuel the gray market and expose companies to many other negative effects.

The gray market, a known issue for technology manufacturers, is the unauthorized sale of new, branded products diverted from authorized distribution channels. Exporting products from a "first sale" country and importing them to another country without the consent or knowledge of the manufacturer, constitutes "gray marketing." This specific gray market activity is also referred to as parallel importing.

It is not just high tech companies that suffer from the gray market. Consumers and other technology end-users are also impacted negatively when products are advertised as new and authentic, when in reality could be used, refurbished, or even counterfeit[6], as a consequence of the commingling that can occur in uncontrolled channels. As result, products that are sourced through gray market channels often do not match quality or service standards of those sourced through authorized channels. This may cause issues with original warranty and support services, which can significantly impact customer confidence and satisfaction, while tarnishing the company's overall brand image.

This report seeks to clarify the extent of the threat caused by channel incentive abuse, and identify industry-wide issues and challenges that may be fueling the gray market. With an appreciation for the essential role that channel partners play in the success of the high tech industry, this paper also suggests practical tools and internal controls to help prevent, and detect incentive abuse problems. Recommendations are based on Deloitte's knowledge of channel incentive management programs and the first-hand experience of AGMA members.

The research, which included both a quantitative survey and a series of one-on-one executive interviews with leading technology companies, was conducted in November 2010. Nearly half of the respondents were drawn from large technology companies with revenues exceeding $25 billion and use a mix of channel distribution strategies—including direct, one- or two-tier, and hybrid models. The majority of respondents also have relationships with a large number of channel partners.

"Different pricing and incentive programs between countries and regions are usually the triggers for gray market activity. Depending on the volumes involved, even price differentials of 50 cents can be sufficient to stimulate gray market product flows."

—A major US based IT hardware vendor

Impact to technology companies

A majority of respondents acknowledged that there is abuse of incentives by their channel partners and that this behavior directly impacts their business. According to respondents, **the top three impacts of gray market activity as a result of incentive abuse are the payment of unearned incentives, profit margin erosion, and disruption of the distribution channel environment that can cause companies to act in ways that are counterproductive.**

Respondents reported that incentive abuses may create an unlevel playing field across channel partners, negatively impact their brands, increase the presence of counterfeit products in market, and even reduce customer satisfaction. This point was further underscored by **the vast majority of respondents—84 percent—who agree that incentives are responsible for gray market activity.**

Figure 1: How does gray market activity as a result of incentive abuse affect your company?

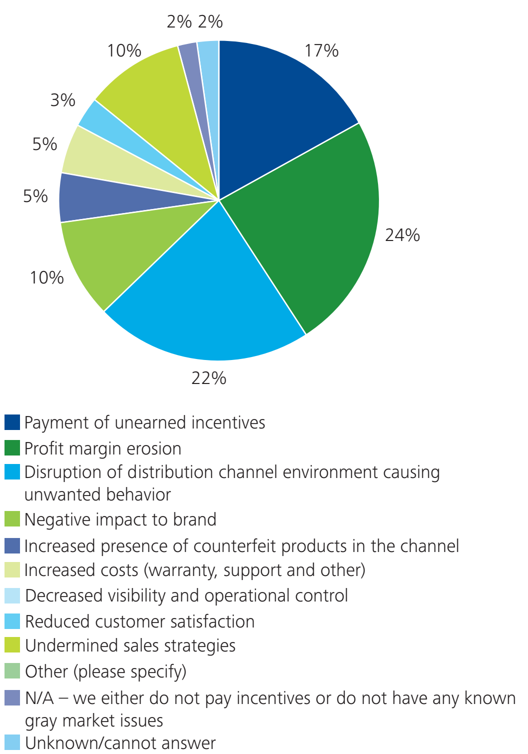
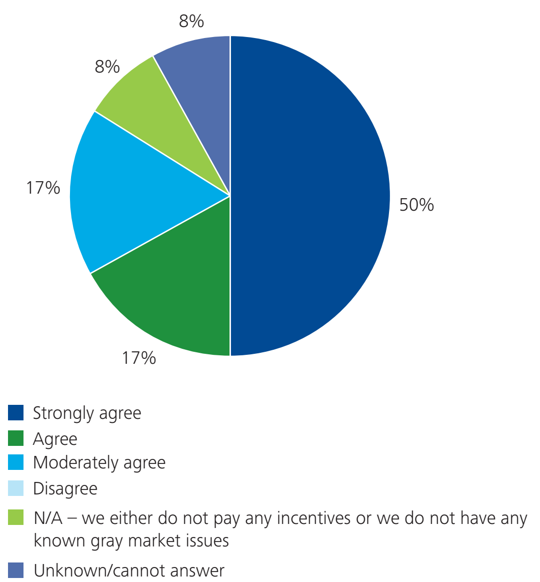


Figure 2: Incentives are responsible for gray market activity



Industry-wide issues and challenges that may fuel the gray market

"The most common abuses are through special pricing requests and other channel promotions, in which brokers buy into the channel partner's deal and purchase products through the channel for sale on the gray market."

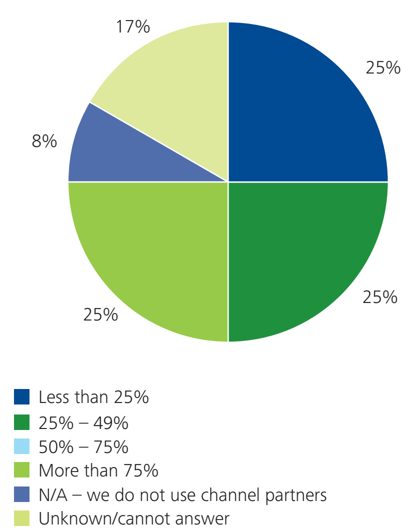
—Benjamin Smith, Vice President, Global Channel Development, APC by Schneider Electric

Given the observed link between channel incentives and the gray market, an important focus of the research was to explore the current state of the industry's vulnerabilities to channel incentive abuse.

The first area of vulnerability comes from the wide-spread use of channel partners within the industry. **In fact, the study found that 67 percent of respondents use more than 5,000 channel partners to bring their products to market.** While the misuse of incentives is an inherent risk of using channel programs, the sheer number of channel partner relationships simply increases the probability of abuse.

Another issue is that companies appear to derive a significant amount of revenue from channel partners. According to the research, **25 percent of respondents derive more than 75 percent of their revenue from channel partners.** An additional quarter of respondents receive between 25 and 49 percent of their revenue through channel partners, which demonstrates the importance of channel partners to these technology companies.

Figure 3: What percentage of your company's revenue is derived from sales through channel partners?



Further increasing the potential risk of incentive abuse is the finding that over **50 percent of channel sales are incentivized, according to two thirds of the companies surveyed.** In today's highly competitive markets, companies are heavily investing in efforts to increase market share. Channel incentives are a significant part of this strategy. This fast-paced, complex environment is another potential factor in incentive abuse.

The types of incentive programs implemented by respondents varied, however the survey focused on the following three categories: end user, programmatic, and channel partner accreditation level[7].Almost two-thirds of respondents felt that end-user incentives had the greatest potential for abuse. In part, this is because most companies have little view of the 'onward' sale of their products, and therefore are forced to rely on the accuracy of their channel partners' reporting with no way to check reported information. This creates an opportunity for channel partners to abuse incentives.

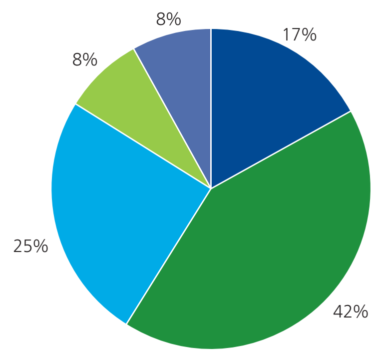
In fact, it was estimated by a majority of respondents that **as much as five to 10 percent of incentivized products are diverted to other end users, thereby resulting in a potentially significant flow of gray market products.**

A compounding effect

Almost all respondents use some combination of end user, programmatic, and channel partner accreditation level incentive types, and many use all three. It is this last point—**the finding that an overwhelming percentage of incentives are 'stacked' or combined in a single transaction—that appears to be problematic.** It is important to note that three quarters of the study's respondents commonly combine multiple offers or process sales through more than one program.

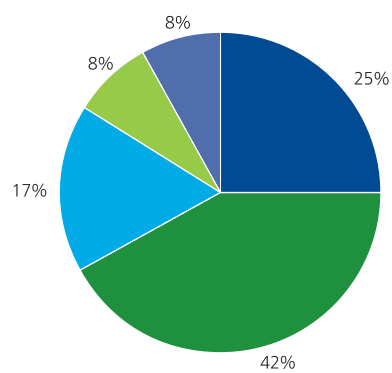
Stacking itself creates a number of the potential problems. Due to added complexities in combining various incentives into a stacked transaction, it also makes it much more difficult for most companies to track whether channel partners are in compliance with all the terms and conditions of each incentive.

Figure 4: What percentage of your company's sales made through channel partners are subject to incentive payments?



- Less than 25%
- 25% – 49%
- 50% – 75%
- More than 75%
- N/A – we do not use channel partners or pay any incentives
- Unknown/cannot answer

Figure 5: What quantity proportion of products which received end user incentives do you suspect to be diverted to alternate end users?



- Less than 5%
- Between 5% – 10%
- Between 10% – 25%
- Between 25% – 50%
- More than 50%
- N/A – we either do not pay End user incentives or we do not pay any incentives
- Unknown/cannot answer

According to the study, stacking also increases both the probability of exploitation and the potential cost of the abuse. When asked to quantify each type of promotion, the majority of respondents indicated that **the total level of incentives on a single sale could be upwards of 25 percent.**

Example of stacked incentives

List price:	$1,000
Contractual discount (25%):	<$250>
Channel partner accreditation (12%):	<$120>
Programmatic (8%):	<$80>
End user (10%):	<$100>
Net revenue:	**$450** (55% off list price/40% off contractual discount price)

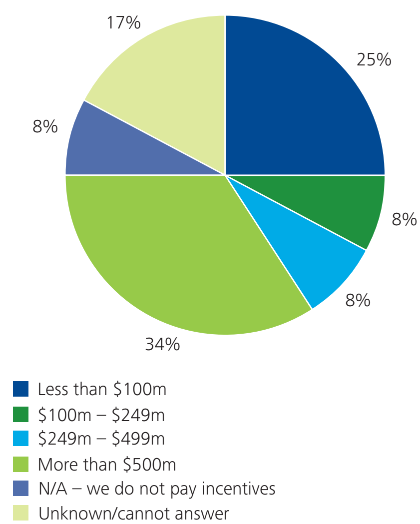
In the example above, a product normally priced at $750 (after contractual discount) would be further discounted to $450 through the stacking of incentives, resulting in a 40% drop in revenue. That product could wind up being sold by a channel partner at the market price, creating a significant margin for the channel partner, or even purchased for resale by unauthorized dealers at the discounted price. This can undermine the market value, or the value that the product is selling for in the market without incentives.

Not only would the manufacturer lose out on the full revenue of the product, but the investment they made, via incentives, would be fruitless. Furthermore, the proliferation of a product in the gray market at a deeply discounted price may decrease the overall market revenue potential of the product. This is because a company is often forced to increase discounts in the authorized channel in order to compete with the same product being sold through the gray market.

A little known, but significant issue

Another research finding was the total amount that individual companies pay out in channel incentives. According to one-third of those surveyed, **the total annual value of incentives is significant, being above $500 million for each company.** Given that most respondents estimated that 5 to 10 percent of incentives are abused, this could represent **$25–50 million[8] to an individual company's bottom line.**

Figure 6: Approximately how much does your company pay out in incentives on an annual basis?



While this figure is certainly a cause for concern, it is important to realize that the total value of incentives may be even higher. Since different types of incentives often are handled by various groups within a company—such as marketing, sales operations, and channel management—many companies lack visibility into the true volume and amount of incentives being paid, and their impact on the bottom line. As described later in this report, many companies may not have the mechanisms to track total incentive payments across various programs, potentially allowing this problem to go undetected.

Geographic considerations

Geography also appears to play a role in incentive abuse. Since incentives often differ between geographies, the resulting price differentials can fuel gray market activity.

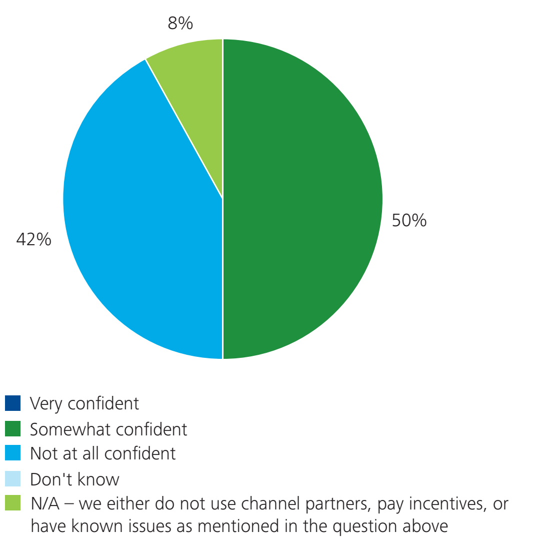
Within the industry, there is a long-held belief that the Asia Pacific region accounts for the greatest share of channel incentives—as well as incentive abuse. This perspective was confirmed by respondents who identified the Asia Pacific region as having the greatest share of incentives as a proportion of company revenue (31 percent of respondents). This is compared with only 17 percent of respondents who identified the Europe-Middle East and Latin American regions as receiving the greatest share of incentives. When asked which market represents the largest *source* of gray market products, many respondents again selected Asia Pacific—this time by more than one third of companies included in the survey.

Geography-related channel incentive abuses appear to stem from two primary issues. First, since many companies are trying to establish themselves in emerging markets such as Asia, they are sometimes willing to offer large discounts to gain early market share. As a result, price points in Asia are often lower than those in other markets. Secondly, incentive abuse is believed to be more common in this region because the market is rapidly growing. When channel partners quickly expand, they sometimes fail to implement controls and program oversight quickly enough to prevent incentive abuse.

A lack of controls

A lack of proper controls, in terms of how incentives are structured and monitored, appears to be a common problem worldwide. Despite apparent risks, it was surprising to find that **none of the companies included in the survey were "very confident" that their controls were effective.**

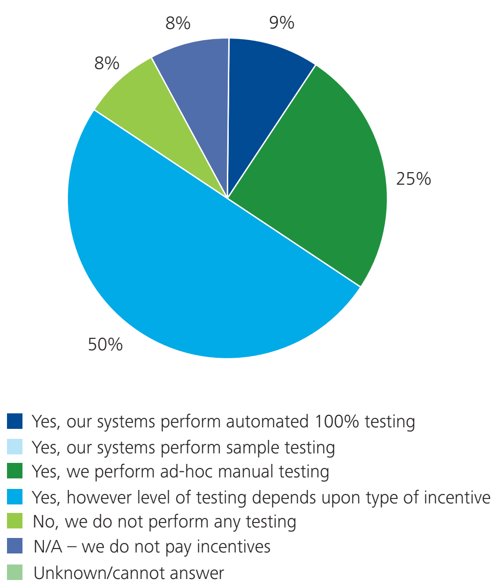
Figure 7: How confident are you that your existing controls identify abused or non-compliant incentive claims, gray market transactions, geographical trends, and issues with specific channel partners?



In addition, the majority of respondents (nearly 75 percent) indicated that their company lacked consistent processes for incentive program development and approvals. These differing policies and processes—such as not clearly communicating or enforcing policies, varying regional processes, and a lack of specific incentive policies—may further support incentive abuse or the diversion of products across regions.

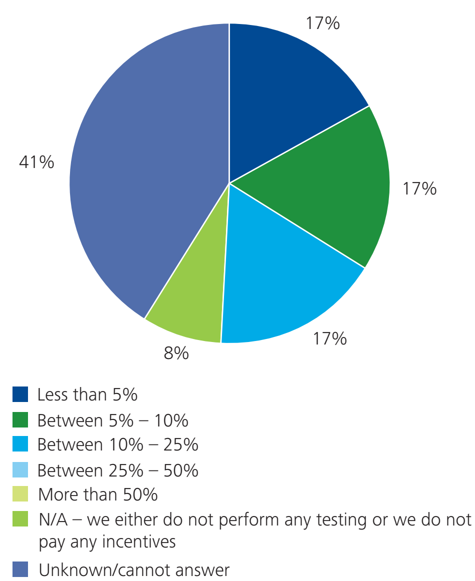
To further complicate matters, channel partner communications, a critical element of incentive management, appears to be lacking. **Twenty percent of respondents indicated that their companies had no compliance program, or that they were not interacting with channel partners on a regular basis.**

Figure 8: Does your company reconcile incentive claims versus the associated terms and conditions?



In addition, when asked about specific controls such as the systematic testing of all incentivized transactions, less than 10 percent of respondents believed that this standard was upheld. **A third of the respondents that were able to answer the question stated that 10-25 percent of tested claims were identified as being abused or non-compliant.** And once a non-compliant transaction was identified, respondents' companies often chose not to reclaim incentives from channel partners, citing a lack of resources as the main reason for this decision.

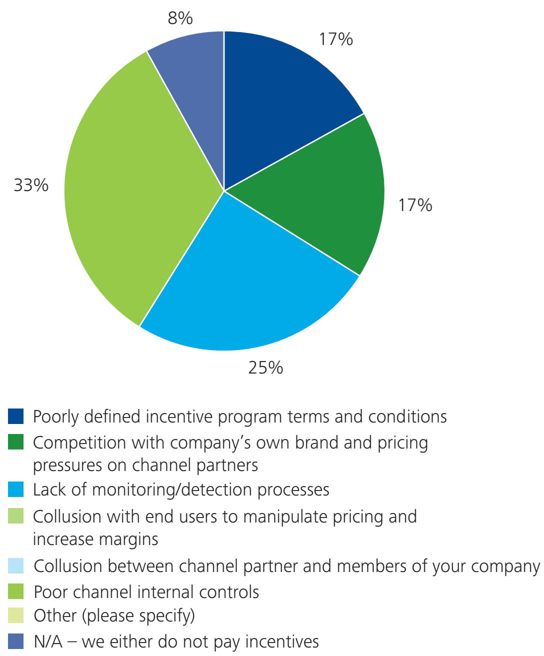
Figure 9: What percentage of incentive claims tested internally within your company is identified as being abused or non-compliant?



Another finding was that **poor channel controls were the main reason for incentive abuse,** according to one third of respondents. Other reasons cited by respondents included a lack of monitoring and detection processes, pricing pressures on channel partners, and competition with the company's own brand from the gray market, as well as poorly defined incentive program terms and conditions.

Since potential problems may proliferate when companies do not evaluate the entitlement and effectiveness of incentive programs over time, and monitor them for compliance, the link between channel incentives and the gray market appears logical. There is a potential inherent risk that channel partners, which typically operate on tight margins, may take unfair advantage of the incentive programs which could negatively impact a brand owner's profitability.

Figure 10: Which of the following do you consider to be the key reason for channel partner non-compliance with incentive program terms and conditions?



"Vendors are not responsible for partners choosing to get involved in the gray market. However, they are responsible for making sure that they do not create the conditions in which the gray market can flourish through neglecting internal processes such as discounting, deal approval, and contracts."

—Chris LaChapelle, Director, Business Unit Operations, Qlogic, Vice-President – AGMA

How to implement an effective channel incentive management program

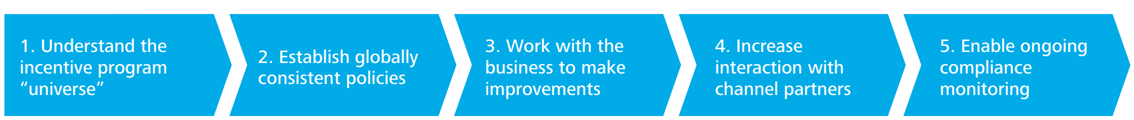
Since the research uncovered certain specific business risks, it is clear that companies across the industry may benefit from improving the effectiveness of their channel incentive management programs.

Reducing a company's exposure to channel incentive abuse may be accomplished by following a series of clearly defined steps. At a strategic level, while it is important to support a company's sales objectives, having proper checks and balances can reduce the risks and increase the returns on channel incentive investments. This is done by creating consistent processes to monitor and verify the compliance of all claimed channel incentives with the terms and conditions of the incentive program, while enforcing protocols to address non-compliance.

In terms of implementation, there are five essential steps to help companies prevent abuse that may increase the likelihood of improving the returns on their incentive programs.

1. **Understand the incentive program "universe"**
   Various incentives are typically administered by different parts of the company, such as sales and marketing, and also treated differently across regions. These different parts of a company often act as silos and do not communicate with each other. As a result, it is imperative to better understand all the incentive programs that are currently in place from a combined point of view. Performing a discovery phase to capture the various data points is critical in order to get a better understanding of:
   - The types of incentives that exist and how the terms and conditions are structured, so that (i) the universe of incentives can be measured and tracked, (ii) differences and similarities between programs can be understood, and risks associated with each program can be captured and addressed
   - The objectives of the incentive and associated metrics (usage of specific incentives, trending, volumes, etc.) can be tracked, so that (i) the overall program ROI can be measured and, (ii) the company understands the factors behind successful programs and uses this knowledge towards future incentives
   - There are regional or functional groups that administer and manage each incentive program, in order to establish accountability for each of these programs

Figure 11: Steps to implementing a channel incentive abuse prevention program



> "In our experience, there are often layers and layers of programs. This is partly due to the fact that incentives are managed by different groups. In many cases, it is difficult for our clients to track and understand them all, which may lead to an increased risk of incentive abuse."
>
> —Brent Nickerson, Partner, Deloitte & Touche LLP

The output of this discovery phase may yield greater visibility into a company's approach to incentives, as well as channel partner behavior and the drivers for these actions. The information gathered can provide the opportunity to reduce overlap between some programs and enable more coordinated decision making for the development of future efforts.

2. **Establish globally consistent policies**

   Given that the management of incentives is often fragmented, the structure and associated risk of each program may vary dramatically. The result is an environment in which program risks may not be clearly understood, and where compliance and control may be challenging to achieve.

   In order to regain an applicable level of control, companies should develop incentive programs that can be managed according to consistent company-wide policies, taking into account the following factors:

   – Policies and guidelines should be developed to enable consistent evaluation and management of incentive programs throughout their lifecycle—from design, introduction, monitoring and testing, and determining and addressing non-compliance, to tracking achievement of ROI or other objectives

   – Although regional or geographic intricacies cannot be ignored, program terms and conditions should be held to a globally consistent standard

   – Such policies should be communicated consistently to relevant stakeholders, and channel partners should be given direction regarding their compliance requirements, including remedies in the case of non-compliance

The output of this phase may create a level playing field for incentives to be administered in a consistent and controlled manner.

3. **Work with the business to make improvements**

   Embedding compliance in the core of a business is clearly an ideal approach, since sales teams not only have the most interaction with channel partners, but are often important players in developing sales strategies and incentive programs. As such, increasing the number of touch points with a company is a critical step since it can:

   – Promote the culture of compliance within the business and highlight that these efforts are critical to achieving sales objectives

   – Educate sales/account teams to spot potentially non-compliant deals or unwanted behavior

   – Set up incentive programs according to the applicable corporate standards, regardless of objective or region

   – Enable input regarding how future incentive programs wold support the business and its goals, and how to measure program ROI

To support the success of incentive programs, it is important to continuously improve organizational processes and institute changes as a result of the issues identified through monitoring and other compliance activities.

> "A recently updated policy regarding incentive set-up and approval has greatly impacted the ability for gray market products to be flooded into the channel."
>
> —Scott Olsen, VP Pricing Management, APC by Schneider Electric

4. **Increase interaction with channel partners**
   Increasing the links between the compliance team and the sales organization is one way of gaining visibility of a channel partner's behavior, but such efforts should also be embedded into a channel partner's business-as-usual activities—rather than engaging channel partners only when problems arise. Compliance has a role to play in every stage of the channel partner life-cycle and can add value to:
   - Channel partner selection: performing due diligence regarding channel partner processes and their ability to be compliant
   - On boarding: providing training focused on business ethics, incentive programs, terms and conditions, and reporting requirements
   - Channel partner lifecycle management: providing insight into discussions regarding strengthening/terminating relationships
   - Feedback: communicating channel partner performance and providing customized training related to any identified issues
   - Follow up on compliance issues: accelerating frequency of contact with previously non-compliant channel partners to improve future compliance

At the very least, these activities may raise the level of channel partner awareness regarding the value a company places on compliance.

5. **Enable ongoing compliance monitoring**
   Without a doubt, activities focused on making important program changes such as those mentioned above can considerably improve a company's overall level of control. However, channel incentive programs that lack ongoing due diligence, such as monitoring, are often ineffective. Companies need to establish systematic touch points to continuously monitor channel partner behavior. It is understood that compliance resources may be limited, but there are a number of approaches, as listed below, which can deliver both effective and efficient compliance monitoring:
   - Channel partner self assessments: requesting channel partners to self assess their internal control environment/ability to comply with incentive terms and conditions, or areas of concern
   - Remote assessments: monitoring the Internet and other sources for price anomalies, or performing desk reviews on data submitted by channel partners to determine compliance
   - Onsite inspections: focusing on critical areas or incentive programs (such as performing end-user verification procedures), or an onsite inspection that assesses all aspects of a channel partner's compliance with their contractual obligations, including Foreign Corrupt Practices Act ("FCPA") and export compliance

"We pay incentives based on self-reported data. We employ third-party data screening services to monitor the data for completeness, accuracy and timeliness. In addition, we perform compliance audits after claims are paid. Close contact with our channel partners and a good knowledge of their customer base and business environment should always be part of the process."

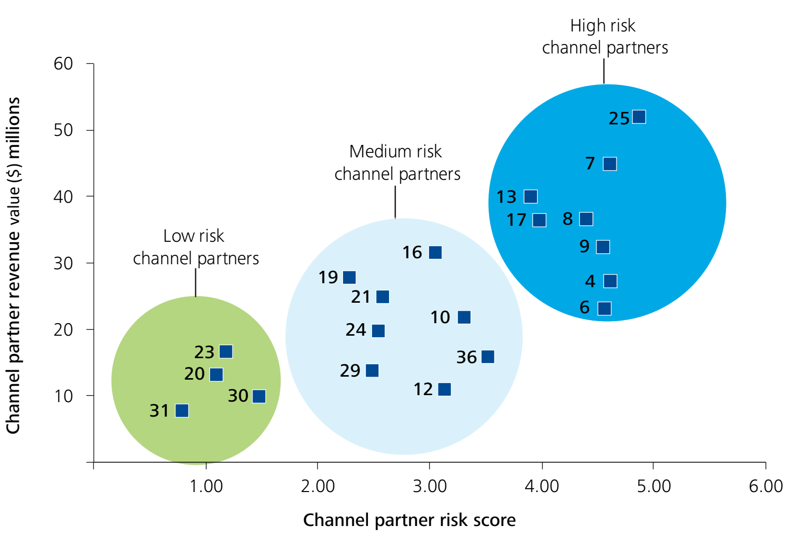
—A major U.S.-based IT hardware vendor

It is important to focus efforts and resources on the riskiest channel partners, and programs. In order to cast the net as wide as possible, it is essential to deploy a variety of compliance activities relative to the risk of each channel partner or program.

Channel partner risk can be determined in a variety of metrics. The impact of channel partner abuses is typically measured through the channel partner's overall revenue, while the likelihood of abuse can be captured through metrics such as value of incentive claims, accuracy of reporting/incentive claims, strategic importance, and suspicions of non-compliance. This is illustrated in the following diagram.

> "There are a number of key areas in the fight against the gray market. Improving processes around serial number tracking, introducing anti-gray market contract clauses, and enhancing policies to control the level of discounts are all important. In addition, working with the business is critical. Having a close link to sales teams and the service organization can make the process less reactive and be invaluable in minimizing and detecting gray market issues early on."
>
> —Donald J. Peterson, Gray Market Prevention & Compliance, AVAYA

Figure 12:



> "Being close to the channel is important. We often receive notifications of potential gray marketeering from our loyal partners as well as our sales teams."
>
> —Phyllis Massey, Manager, Brand Protection, HP

Gaining control

The state of channel incentive abuse may be worse than previously thought. The fact that the industry may potentially be missing out on an estimated $1.4 billion[3] in profits each year due to these abuses is nothing short of staggering.

While the actual amount of incentive abuse within the channel is hard to measure and often goes undetected, the resulting problems are painfully evident. Individual companies are paying millions in unearned incentives, and dealing with everything from the negative impact to their brands, to increased presence of counterfeit products in the market, and erosion of profit margins. Together, these factors may help fuel the gray market and enable it to thrive.

But finding a viable solution has been challenging. A long-held misconception—that the profit and other benefits of channel incentive programs inevitably create risks such as profit erosion—has prevented many companies from acting. This is understandable, given that many high tech companies are largely dependent on channel partners for their success and therefore do not want to jeopardize these critical relationships.

However, with a better understanding of the mechanics and causes of the abuse, a focused effort, sufficient resources, and senior management sponsorship, companies can make progress in reducing their own unintentional support of the gray market. And, this can be done without undercutting important sales initiatives. In fact, companies creating consistent processes to monitor and enforce compliance, may become more profitable and retain what might otherwise be millions in lost profits. These processes also facilitate a better functioning distribution channel environment, which also supports a company's revenue goals.

Put simply, strong channel incentive management programs can and should be a win-win for technology companies and channel partners alike—rather than a choice between control and profits.

"It is not enough to have strong contracts that outline expectations. Open communication between vendors and their partners is vital to ensuring that partners fully understand their contractual obligations. Good communication will also help foster a controlled environment that will discourage non-compliant activities. Lastly, contracts must be consistently enforced to clearly demarcate the boundaries of acceptable behavior."

—Vivian Vassallo, Sr. Director, Global Compliance, Dolby Laboratories

Important controls for reducing incentive abuse vulnerabilities

Contract terms and conditions

- Review and update contract terms and conditions to include clear, and appropriately narrow specifications about how incentives may be applied
- Outline terms and conditions that do not create conflicts with other programs
- Create terms and conditions that a channel partner can reasonably comply with as part of their normal business processes
- Structure programs so that they hold some inherent benefit for the channel partner beyond financial gain

Serial numbers

- Include unique serial numbers on all products sold, including the subcomponents
- Maintain records of active combinations of part numbers and serial numbers
- Consider serial number lists or databases to be confidential, and protect them as such
- Require product serial numbers to be included on 'sales out' reporting

Channel partner program management

- Compensate channel partners at a competitive rate
- Institute a rigorous certification process for channel partners
- Define incentive management processes and penalties in clear terms, prior to entering into a channel partner selling agreement
- Require annual recertification of the awareness and compliance with the vendor's policies
- Create frequent, ongoing channel partner communication vehicles that make use of Web site content, newsletters, email updates, and brochures
- Establish channel partner relationship managers who are rewarded for compliance levels of their accounts
- Implement regular touch points between channel partners and the compliance representative

Monitoring

- Establish centralized management of incentives to govern all aspects of the company's programs
- Provide executive-staff sponsorship and accountability for centralized incentive management
- Track risk-reward of incentive programs by program and region
- Discontinue programs when they no longer have economic or strategic impact
- Include input from marketing, sales operations, channel management, and compliance as well as any other group within the company that deals with channel incentives
- Monitor the Internet and other sources of promotional materials for price anomalies
- Develop escalation and incident management procedures to handle identified gray market issues

Systems

- Develop systems that automatically reconcile incentive claims to the associated terms and conditions
- Implement automated systems to test the authenticity and incentives entitlement for each sale
- Focus on systems to address end-user and multiple incentive purchases first
- Develop systems to track and analyze all non-compliance findings

Testing

- Establish clear processes for ongoing testing in accordance with all compliance activities
- Where testing programs lack structure, begin by implementing an ad-hoc or sample testing program for incentive claims to determine if they meet the associated terms and conditions
- Use early findings from ad-hoc tests to determine priority regions or programs for further testing

Non-compliance protocols

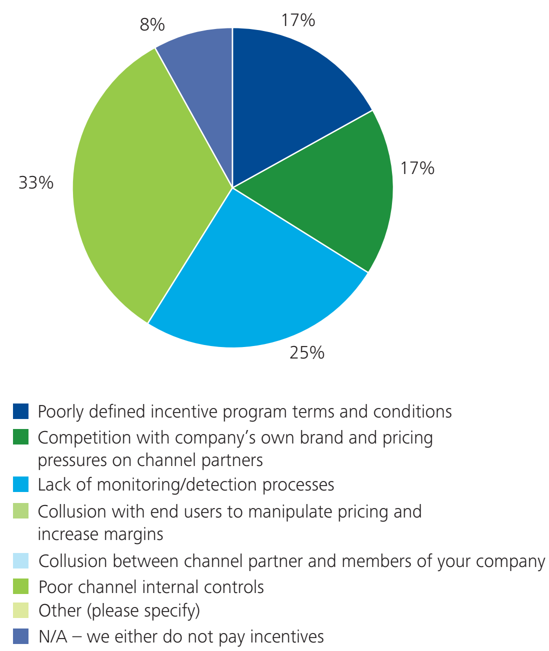
- Define and communicate significant non-compliance remedies, such as financial retributions and potential liabilities, to sales staff and channel partners
- Institute consistent incentive recovery procedures for non-compliant transactions

Common causes and sources of incentive abuse

An essential aspect of incentive program abuse is the channel partner's desire to increase margins. This is facilitated by a number of factors, some of which are generated by the company, while others may be due to channel partner behavior.

1. *Poor channel internal controls*
   A lack of monitoring and detection processes may increase the likelihood of channel partners engaging in inappropriate incentive claims where they feel the chances of being caught are low. Similarly, poor internal incentive administration processes may create the conditions for incentive abuse, resulting in an increase in inappropriate incentive claims. Enhancing internal controls, such as controls for granting end-user discounts when a program is first set up, would help reduce the potential for abuse within the channel and may reduce opportunities before the claim is even submitted to a company.
2. *Lack of monitoring and detection processes*
   If a company is known for inadequate detection processes, the likelihood of channel partners' incentive abuse considerably increases. Not surprisingly, it appears that the companies with stricter processes also have fewer issues with the gray market.
3. *Competition with a company's own brand and pricing pressures on channel partners*
   When unethical channel partners are also dealing in gray market products, then their price points are likely lower than those ethical channel partners that are sourcing only from authorized channels. This may create an unlevel playing field that in turn could increase pressure on ethical channel partners to lower their price points by abusing incentives, or potentially cause them to seek gray market products in an effort to compete.
4. *Poorly defined incentive program terms and conditions*
   In some cases, companies introduce terms and conditions that channel partners may have to circumvent in order to comply with their own standard procedures, or establish terms and conditions that can be broadly misrepresented. Another example of a poorly defined program is when channel partners perceive an insufficient remuneration, resulting in a feeling of pressure to increase profit and achieve required margins through abusing other incentives.

Figure 13: Which of the following do you consider to be the key reason for channel partner non-compliance with incentive program terms and conditions?



Sample control weaknesses that may contribute to opportunities for channel incentive abuse

- **Inadequate channel incentive program management –** There is a lack of structure, centralized control, and oversight when it comes to the administration and management of incentive programs. In practical terms, this often means that there are few policies or procedures in place to make sure that programs are managed consistently.
- **Lack of formal process for approval and communication of incentive programs and requirements –** Making sure that programs are set-up correctly is critical. Many companies create conflicting programs—programs with terms for which channel partners cannot comply as part of their normal business processes, or programs that are not in the best interest of the company.
- **Decentralized management of incentive programs causing vast differences in pricing across regions –** Different regions may create vastly different price points, which would result in significant increases in gray market activity. This impacts the country-specific revenue and overall profitability of the company.
- **Manual or inadequate monitoring of compliance with incentive terms and conditions –** Maintaining a high level of vigilance regarding channel partner compliance is clearly an important, yet resource-intensive exercise. But without these controls, there may be nothing to stop channel partners from abusing incentive programs.
- **Inadequate resources to research and follow up on identified incentive abuse –** Even where issues with compliance are identified, the effect on the channel partner is the same if there is no one to follow up and act on non-complaint findings.
- **Poor "tone at the top" regarding the importance of compliance and a willingness to address non-compliance by channel partners –** Companies with strict policies that do not tolerate violations typically have fewer channel issues.

Gray market impacts

1. **Revenue** Where products are diverted from intended geographies or sold to the unintended end customer—allowing the end customer to receive a higher-than-normal discount—a brand owner's revenue and profitability may be directly impacted. Incentives are often claimed through back-end rebates and self-reported sales. These sales when reported inaccurately result in an overpayment of incentives. Furthermore, overpayment often arises when incentives for specific end customers are diverted to different individuals that are not entitled to that level of discount—or when the difference is retained by the distribution channel partner.
2. **Cost** When gray market products require after-sales product support or warranty, it clearly impacts a company's revenue and profitability. This is because applicable support fees have not been paid. In addition, a company may incur the costs associated with warranty and support service, when they choose to absorb the losses and provide support in order to preserve their brand image. The problem of warranty and service fraud may be further exacerbated in the cases involving counterfeit products.
3. **Relationships** Having even a small number of unscrupulous channel partners that deal in gray market products can manipulate product price points and make it harder for scrupulous channel partners to source from authorized channels. This has a carry-over effect, potentially making the gray market more prevalent, undermining the company's sales strategy, reducing visibility and control, and ultimately impacting the company-channel partner relationship.
4. **Reputation** Price points often distinguish leading brands from less desirable brands. As a result, when end users see differing price points for the same brand in the market, it may negatively affect a brand value. And if a gray market product is not supported by companies, then end users may be financially and operationally impacted, thus lowering end-user satisfaction with the brand and potentially tarnishing a company's reputation.

Call to action

Most organizations implement Contract Risk and Compliance (CRC) programs to improve the efficiency and effectiveness of their contract monitoring processes, and to improve processes that involve business relationships. In our experience, the ROI impacts of CRC efforts kick in quickly, often in a matter of weeks.

It is natural that some unrealized revenues or cost savings occur after a relationship is up and running, and a CRC program addresses such situations. It is also natural for trust to either increase or decrease over time. When clear expectations are set and facts and figures evidence a record of dependability, trust increases. In the absence of clear expectations and facts and figures, trust can erode.

A CRC program sets a context and becomes a vehicle for each party to communicate about risks, rewards, results, and concerns regarding the relationship, enabling each to realize the benefits of trust in a commercial relationship: faster execution, improved reporting, warning of potential problems, increased peace of mind, and enhanced profitability.

In these challenging times, it is vital to validate that all third parties, including suppliers, service providers, channel partners, and outsourcers do not succumb to pressures to control their costs at the expense of contract compliance. It's equally important to verify they are delivering on service levels with the quality of deliverables and qualified personnel that they committed to deliver.

Similarly, an uncertain economic climate makes it more important than ever to verify that revenue due under royalty, licensing, and other agreements is properly accounted for and remitted.

A CRC program helps an organization move forward, even under adverse conditions. It provides a framework for diligent application of the basics—defining and implementing the goals, roles, management practices, performance metrics, risk controls, periodic inspections, and occasional course corrections—that keep an extended enterprise on track. A CRC program can help:

- Enhance the value of your business relationships
- Produce positive ROI by reducing operational expenses and improving operational processes
- Increase the effectiveness of your extended enterprise management
- Enhance overall understanding and appreciation of shared business goals
- Increase confidence in and accuracy of information received from others
- Identify potential revenue opportunities
- Limit gray market activity
- Foster customer and channel partner feedback
- Strengthen internal controls

Endnotes

1 Channel incentives are defined as end-user pricing, channel partner accreditation and programmatic incentives (such as SPIFFs, product promotions, channel partner program discounts, etc.). For the purpose of this research, incentives do not include MDF, co-op and other funds for marketing activities. Source: AGMA, 2010.

2 A channel partner is defined as an authorized partner that assists in the distribution and/or resale of a vendor's branded product, which receives incentives through the purchase and sale of the product through the authorized channel, including distributor, value add distributor, reseller, value add reseller, solution providers, managed service providers, etc. For this purpose, channel partner does not include OEMs (where vendor's product is re-branded), strategic alliances or influencers. Source: AGMA.

3 The majority of respondents indicated that (i) 5 – 10% of incentives were abused, and (ii) the value of incentives exceeded $500m annually. In order to estimate the per-company profit loss figure, we applied a 7.5% incentive abuse rate to an incentive value of $500m. In order to estimate the industry wide profit loss figure, we multiplied the per-company figure by a population of 38 companies including (i) the 12 survey respondents, and (ii) 26 additional IT hardware or consumer electronics vendors/brand owners with 2010 revenues greater than $10bn (according to http://www.hardwaretop100.org/index.php). Source: Deloitte, 2011.

4 Counterfeit products are typically defined as inferior products sold as the 'genuine article' whereas initially, gray market goods were originally new, genuine products that were then sold or diverted from authorized channels. Counterfeits are non-genuine goods traded with breach of intellectual property including brand and trademarks. It is a deliberate attempt to deceive consumers by copying and marketing goods, bearing a manufacturer's trademark so that these goods look like they came from the original manufacturer. Counterfeits are distributed mainly on-line and via gray market supply chain which appears to be increasingly polluted by counterfeits. Source: AGMA, 2011.

5 Technology companies are defined as brand owners in the high technology industry who leverage channel partners in the distribution of their products and intellectual property. Source: Deloitte.

6 Although it is more an exception than a rule, channel incentive programs can also be infected by counterfeits. For example, where unethical channels source products from dubious sources and sell them in conjunction with genuine products sourced from authorized sources, claiming the sales incentive for the entire sale. In the presence of strong incentive management program, such activity can be identified before the incentives are paid out, and the incident undergoes applicable legal scrutiny.

7 End-user- special pricing is granted for a specific end user and a specific deal. Programmatic, or "blanket" incentives, are often offered to channel partners deals or transactions meeting certain goals (e.g. penetrating new markets, selling to specific industries, such as the government, identifying new customers, or selling certain product lines). Channel Partner Accreditation are margin points granted to channel partners for achieving certain criteria, such as obtaining certifications, attending training, employing specialists.

8 The majority of respondents indicated that (i) 5 – 10% of incentives were abused, and (ii) the value of incentives exceeded $500m annually. We have estimated the per company impact of $25m-$50m by multiplying $500m by the 5 – 10% abuse rate.

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About AGMA®
The Alliance for Gray Market and Counterfeit Abatement (AGMA®) is a non profit organization comprised of leading high technology companies committed to addressing the global impact of intellectual property rights issues; such as gray market fraud, parallel imports, counterfeiting, software piracy, and service abuse of technology products around the globe. The organization's goals are to protect intellectual property and authorized distribution channels, improve customer satisfaction, and preserve brand integrity. AGMA® uses a variety of avenues to cultivate change in the marketplace including, event speaking, educational initiatives, benchmark studies, industry guidelines, and, where appropriate, public policy advocacy. To learn more about AGMA®'s initiatives or to become a member, please visit http://www.agmaglobal.org/ or contact:

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