What's New @ CCI

CURRENT ISSUES, A1

REGULATION & LEGISLATION
A HISTORICAL PERSPECTIVE

OPINION, A2

Trade Allowance Programs and Legal Restrictions

BUSINESS, A1

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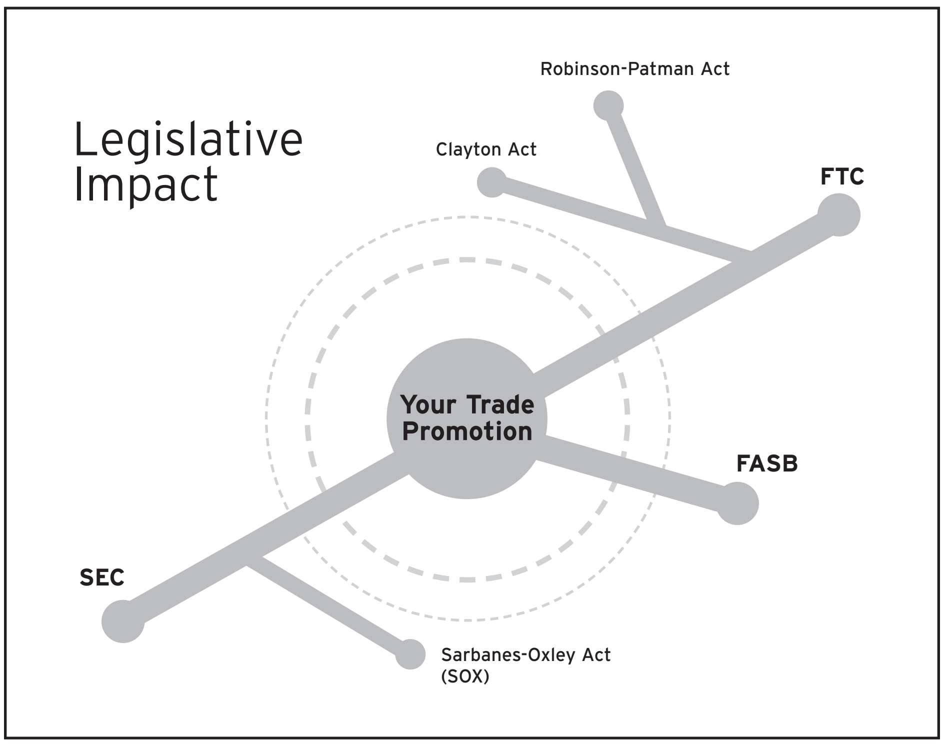
Trade Allowance Programs and Legal Restrictions

By Bill Kelly & Cathi O'Sullivan

Background

Trade allowance programs (TAP's), such as cooperative advertising and market development fund programs, are hybrid beasts. In their simplest form, TAP's are jointly sponsored manufacturer-to-resale partner advertising strategies, which are targeted to the end-user (i.e., customer) of a product or service. The purposes and objectives of TAP's are multi-faceted, but they are largely aimed at inducing the potential end-user to purchase the identified product from the sponsoring resale partner. TAP's are part of the advertising and marketing business intended to move merchandise through channels of distribution to the end-user, and they are also part of the distribution process that is woven into the contractual relationship (both legal and financial) between manufacturers and resale partners.



One typical example of a TAP is a co-op advertising program, an arrangement in which a manufacturing company shares the cost of advertising with its resale partners for featuring their brand of products. It is a true "win-win" as both the manufacturer and the resale partner get more advertising per dollar by sharing expenses. On occasion, co-op advertising is referred to as a separate medium, or as just another place in which advertising dollars are spent. However, co-op cannot be equated with other areas where advertising funds are spent because it is not a medium; it is, instead, a financial arrangement. The fact of this financial arrangement that distinguishes it from all other advertising is that, by its very nature, the arrangement removes a large degree of control from the manufacturer. The existence of one or more intermediaries between the manufacturer and the media is the very characteristic that defines co-operative advertising and, at the same time, limits the degree to which the manufacturer can control the media expenditures.

Legal Restrictions

Currently, there are several new legal restrictions that impact trade promotions. Arguably, the most pressing of those legal restrictions is the Sarbanes-Oxley Act, with FASB rulings taking a close second place. Both the Sarbanes-Oxley Act and the FASB rulings require that manufacturers establish internal financial controls, and they can be a source of some confusion for manufacturers who provide TAP's to their resale partners. Not surprisingly, one source of the confusion is the fact that these legal restrictions are in some conflict with the nature of TAP's. We'd like to provide an overview of these legal restrictions to alleviate confusion starting with some basic background information.

The Securities and Exchange Commission (SEC) Guidelines

The mission of the SEC is to protect investors and maintain the integrity of the securities markets, and all guidelines provided by the SEC are to that end. Following are two major pieces of SEC legislation that trade allowance professionals should know about.

SARBANES-OXLEY ACT (SOX)

SOX is an SEC "public company accounting reform and investor protection act" that was passed in 2002. For our purposes, only specific sections are relevant, most notably Rule 404 which is the "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports."

Rule 404 requires management to present an internal control report in the company's annual report which must contain two vital pieces of information. First, it must include a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Secondly, it must include an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

FASB is not a government agency, but it is a "dotted line" to the SEC. Since 1973, FASB has been the organization designated to establish standards of financial accounting and reporting. The SEC, as well as the American Institute of Certified Public Accountants, recognizes FASB as an authoritative body.

For our purposes, FASB Rulings EITF 01-9 and EITF 02-16 are most pertinent. Both of the rulings deal with the accounting of trade promotion allowances and other related expenses, one for manufacturers and the other for resale partners. 01-9 indicates that all trade payments must be classified as revenue reductions unless they meet all of the following conditions:

- The payment covers a service by the resale partner that offers a clear benefit to the manufacturer

"Restrictions" article continued on A2, column 3

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If you have any questions regarding this change, please contact us at CCI by calling 415.472.5100. This is the same phone number as before. All existing CCI phone numbers are the same.

For more information on this recent and exciting move, please visit www.CCIonline.biz.

The way I see it...

Bill Kelly is VP of Sales for CCI and helps companies define objectives, evaluate strategies and implement programs that achieve measurable results

Regulation & Legislation – A Historical Perspective

Evolution of Co-op Advertising

It has been said that if people do not remember history they are doomed to relive it. The importance of understanding the history and evolution of cooperative advertising both within the individual industry and within the individual company cannot be overstressed.

Trade promotion programs, particularly co-op advertising programs, have been around since before 1900 and have a history of being influenced by legislation. Unlike other elements of the marketing mix that traditionally are within the manufacturer's control, trade promotion program decisions are commonly affected by a variety of outside factors.

> *"Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who ever have been, and ever shall be, animated by the same passions, and thus they necessarily have the same results."*
>
> *— Machiavelli*

Monopolies, Fair Trade and Discrimination

The most significant legislation is known as the Robinson-Patman Act. Its history began with the enactment of the Sherman Anti-Trust Law in 1890 that was aimed at preventing the creation of monopolies. In 1914 the law was amended with the Clayton Act that was designed to prohibit preferential price treatment where the effect would impede normal competition. Here is the history on these legislative acts and their intended purpose:

SHERMAN ANTI-TRUST ACT (1890)

As big business emerged in the 19th century, competition was cutthroat. In a response, trusts and holding companies were created to control price competition through cooperation and coordination of rival businesses. These were, in effect, forms of monopolization. The Sherman Anti-Trust Act is the principal anti-monopoly law and states, "no person shall monopolize, attempt to monopolize or conspire with another to monopolize interstate or foreign trade or commerce."

CLAYTON ACT (1914)

The Clayton Act amended the Sherman Antitrust Act and was designed to promote competition and preserve free marketing. The Clayton Act was the first federal statute that expressly prohibited certain forms of price discrimination by eliminating price fixing and removing barriers to entry for competitive companies.

ROBINSON-PATMAN ACT (1936)

Manufacturers forbidden by the Clayton Act from selectively offering lower prices to preferred resellers could effect the same end by offering discriminatory advertising allowances. The Robinson-Patman Act was designed to plug this loophole. Until the enactment of the Robinson-Patman Act, a manufacturer who wanted to favor one reseller over another could sell products to both of them at exactly the same price and then simply rebate a substantial portion of the price to the favored reseller in the form of a "promotional allowance."

Financial Reporting and Controls

Today there are further restrictions that affect trade promotion programs. Specifically, the Financial Accounting Standards Board (FASB) states that all trade promotion payments must be classified as revenue reductions unless these payments meet four specific conditions.

SARBANES OXLEY ACT (2002)

This Act has had a major impact on the way that public companies are regulated and has significantly increased the level of disclosure and certification required in financial reporting.

Understanding legal ramifications and restrictions plays a dominant role in the planning, administration and reporting of trade promotion programs. Attorneys' opinions will sometimes differ on what is legally permissible. What is legally acceptable today may not be so in the future, and the converse is equally true. Awareness and continuing education are the keys to staying on top of legal changes.

Restrictions

CONTINUED FROM A1

- The benefit is clearly separable from the sale of the product
- The benefit could be purchased from a source other than the resale partner, and,
- The manufacturer obtains proof of performance and can reasonably estimate true costs.

EITF 02-16 (Accounting for Consideration Received from a Vendor by a Customer) extends the rules of 01-9 to resale partners.

For more information on SOX, FASB rulings and how to design compliant and effective trade allowance programs, go to www.CCIonline.biz. More detailed resources and information about CCI-hosted SOX and FASB events will be posted to the website regularly, starting in July, so visit often!

Separate from the SEC but equally relevant to our discussion on TAP's and legal restrictions is the Federal Trade Commission. "The way I see it…" article in this issue of The CCI Journal provides a historical perspective on three of the FTC's most relevant acts, and we'd like to elaborate on two of them as a way of further illustrating how these different governing bodies impact TAP's.

Federal Trade Commission (FTC) Guidelines

The purpose of the FTC guidelines is to highlight legal problems that may be encountered by manufacturers (i.e., sellers) who want to utilize promotional or advertising allowances to stimulate the sale of their products. Simply stated, the law requires manufacturers who offer promotional and advertising allowances to treat their resale partners fairly and without discrimination.

THE CLAYTON AND ROBINSON-PATMAN ACTS

Since the intermediary between the advertiser (e.g., manufacturer) and the media is, in most cases, the advertiser's customer (e.g., resale partner), and because that customer's costs can be affected by advertising allowances, co-op advertising is regulated by a piece of Federal legislation established for the purpose of protecting small resale partners in the area of pricing; this legislation is known as the Robinson-Patman Act.

The purpose of the Robinson-Patman Act is to plug a loophole that had been found in the Clayton Act. The Clayton Act prevented manufactures from selectively offering lower prices to preferred customers, but manufacturers could bypass the rule by offering discriminatory advertising allowances. With the addition of the Robinson-Patman Act, a manufacturer could no longer favor one resale partner over another by selling products to them at the same price and then reimbursing one of the partners in the form of a "promotional allowance."

The Robinson-Patman Act's objective is to prevent competitive inequalities. This act requires a manufacturer to treat competing resale partners on equal terms where the resale of the manufacturer's products is of like grade and quality.

Next steps

Understanding the basics of these legal restrictions is a good start, but it's important to take action to meet the legal requirements. Call Bill Kelly at 415.472.5100 x210 to find out more.

CO-OP PROGRAM REQUIREMENTS

When a seller offers a co-op advertising program to his customers, he should meet several requirements:

> The program should be available on proportionally equal terms to all competing customers (i.e., no discrimination).

> The seller should take action to inform all of his competing customers of the existence of and the key features of the promotional plan in time for them to take full advantage of the program.

> If the basic plan is not functionally available to some of the competing customers, an alternative plan should be offered to those customers.

> When informing the customers of the details of the plan, the seller should provide them with enough information to give them a clear understanding of the exact terms of the program and the conditions upon which payment will be made.

> The seller should take reasonable precautions to see that the services are actually performed and that he is not overpaying for them.

Third-party Liability for Double Billing

An advertising medium (e.g., newspaper, broadcast station, printer, etc.) which publishes a rate schedule containing fictitious rates, or furnishes a customer with an invoice that does not reflect the customer's actual net advertising cost, may be in violation of the FTC if the customer uses such deception for a claim for an advertising allowance.

Meeting Competition

The only time a seller may offer higher payments or increased services to a customer without doing the same to all of his customers is when the seller is meeting the competition. If the seller's payments are made in good faith to meet equally high payments made by a competing seller to a particular customer the seller does not necessarily have to offer the payments to all of his customers.

For more information…

If you want more information about what was stated in this article, please see the following websites:
www.napaa.org
www.cio.com/archive/051503/rules.html

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