

Performance Management & Incentives in the Era of Sarbanes-Oxley



In the wake of Enron, WorldCom and other corporate governance and accounting scandals, federal legislators in 2002 enacted the Sarbanes-Oxley Act (SOX), which was designed to improve the accountability of corporate managers to shareholders and to improve public confidence in publicly traded companies. While most of its provisions do not directly apply to the use of incentive

programs, SOX is giving corporations new reasons to apply even more rigorous research-based standards and professional practices to their incentive and recognition program design.

The SOX legislation applies to publicly traded firms with a minimum market capitalization of \$75 million. The act's purpose is to raise the standard of corporate governance and financial disclosure. Specifically, it establishes

accounting oversight for corporate boards and managers, limits the type of work that accounting firms can do for their clients, bans corporate loans to executives, expands protection for corporate whistleblowers and, most importantly, requires more accurate and more detailed financial reporting.

SOX requires companies to create and maintain internal controls and processes for financial reporting, provide for full disclosure on any material changes in their financial condition or operations, set up procedures for detecting fraud and ensure that their financial records are complete and up-to-date.

While the Sarbanes-Oxley Act does not address incentive plans directly and does not legally apply to private companies, there is an impact as companies in general seek to improve their ethical, recordkeeping and accounting practices to increase the transparency of all expenditures throughout their organizations. Many companies are looking for more precise and accurate tracking and justification of all of their marketing efforts, including incentive programs, in order to provide a better rationale for business development and any expenditures related to compensation, rewards or recognition. This may help explain why the use of professional incentive companies for program planning purposes has almost doubled in the last two years, according to a recent study by the Incentive Federation (www.incentivecentral.org).

SOX controls give companies, their

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officers and their managers additional reasons to be more stringent in their maintenance of financial records—including incentives and recognition programs. If a current incentive plan is not well defined and awards are distributed without tracking, these programs could face elimination or other repercussions arising from internal or external audits.

It will take time to clarify many of SOX's new requirements and definitions, some of which are still somewhat broad and uncertain. But in the meantime, enforcement agencies like the Securities and Exchange Commission, NASD and state attorneys general seem to be applying the broadest possible definitions and using the law as a springboard for investigation and legal action in some industries targeting

compensation-related practices and other payment arrangements. Some of these actions, most notably by New York State Attorney General Eliot Spitzer, do not specifically relate to SOX statutes but help contribute to an atmosphere of greater scrutiny of all compensation-related practices. The financial services and insurance industries have been particular targets of some of these investigations. This new scrutiny gives corporations very good reasons to use incentive and recognition programs that meet professionally recognized standards based on research.

SOX Specifics

The Sarbanes-Oxley Act comprises many sections, each highlighting different requirements for public companies. The sections that warrant

the most attention for people involved with incentive programs or compensation are those sections focused on corporate systems and accountability. Following is a brief overview of these sections:

Section 302—Corporate Responsibility for Financial Audits:

The CEO or CFO of a company must certify the appropriateness of the financial statements and disclosures contained in the annual report and that these statements and disclosures fairly represent the operations and financial conditions of the company. Knowing any intentional violations will give rise to liability. If unscrupulous executives have used incentive payments to distort revenue or profit results, it's a potential violation. Abiding by and documenting professional incentive campaign design guidelines help organizations get the benefit of such programs without running regulatory or ethical risks.

Section 401—Disclosures in Periodic Reports:

Financial reports shall disclose all material off-balance-sheet transactions and other relationships with unconsolidated entities that may affect



current or future financial conditions. In particular, the SEC will be looking for errors and omissions that might make such statements misleading. Properly planned incentive programs have fully documented expenditures and organizational benefits.

Section 404—Management Assessment of Internal Business Controls: Each report must include an “internal control report” that certifies management’s responsibility for creating and maintaining internal controls and processes for financial reporting. In addition, management must assess the effectiveness of the internal control structure and procedures on an annual basis. This means that if the company is investing in an incentive program, it should be able to clearly identify the purpose for and the return on that program and document all associated costs. It also helps when companies use professional program design guidelines based on research.

Section 409—Real-Time Issuer Disclosures: Companies must disclose information on material changes in their financial condition or operations on a current basis. The ability to provide detailed program records and real-time reports on changes to incentive program systems should become very valuable to companies seeking to comply with the standards or spirit of Sarbanes-Oxley.

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SOX Incentive and Recognition Checklist

- Make sure your incentive program has a measurable business purpose.
- Base program design on research-supported practices.
- Document the business goals, performance measures, strategies and actions justifying any program.
- Track all expenditures, taking advantage of technology offered by professional incentive program designers.
- Use incentive and recognition program experts with demonstrated experience in creating performance-based programs.

Section 802: Gives the SEC authority to establish regulations on corporate retention of memoranda, correspondence, communications and other documents (including electronic records) related to a financial audit or review. Companies must ensure their records are authentic and consistent and that they have, and follow, appropriate record securities and retention policies. Technology helps provide such accounting on a real-time basis.

Section 906: Corporate executives are required to certify that all reports—including annual reports, 10-K’s, 10-Q’s, etc.—provide an accurate representation of the firm’s financial position. This section also details potential penalties for SOX violations, including fines

and imprisonment. Corporate chieftains now have a strong incentive themselves to make sure that the invaluable motivational and relationship-building events they establish have a clear business purpose and are managed, tracked and measured to reflect that.

How SOX Affects Incentive and Recognition Programs

The SOX legislation does not mean that incentive programs are likely to become line items on corporate financial reports, but that companies subject to SOX are likely to become more demanding about justifiability, record-keeping and reporting throughout their organizations, especially as it pertains to undisclosed incentive payment in the form of cash or noncash awards. Corporate executives who are signing off on a company’s financials are more interested in the details of what they’re signing, and these companies are looking for more detailed documentation from their suppliers, including incentive program suppliers. Corporate executives are more reluctant to sign off on incentive programs unless they can be assured of a clear business purpose and benefit, as well as detailed and accurate records.

At the very least, with these tighter financial reporting requirements, public companies will be looking for more detailed reporting and “transparency” in their incentive programs of all types. SOX doesn’t mean the end of motivational or relationship-building events, but a new emphasis on their underlying business purpose. Because properly designed incentive programs can have a clearly demonstrated ROI, all SOX does, in effect, is obligate public companies to take these programs more seriously.

That means designing programs based on measurable best practices. A lavish event can land an executive in jail if used to circumvent accounting practices, or be part of a formal strategy that helped earn him or her a bonus for achieving a double-digit sales increase and near-perfect customer satisfaction scores. By running formal programs with well-documented performance improvement benefits, organizations in

Where to Go for More Information

The following Web sites provide research, how-to information, best practices, program design curriculum, supplier listings and more:

Incentivecentral.org—the not-for-profit portal of the Incentive Performance Center

Performanceforum.org—the Web site of the Forum for People Performance Management and Measurement in the Department of Integrated Marketing Communications of the Medill School at Northwestern University

Incentivemarketing.org—the Web site of the Incentive Marketing Association, which operates the Performance Improvement Council, comprising the nation's leading performance improvement and incentive companies

Recognition.org—the Web site of the National Association of Employee Recognition, which upholds the highest standards of recognition program design

Site-foundation.org—the Web site of the SITE Foundation, which funds original research in the area of performance improvement and incentive programs



every industry can clearly distinguish their results-based motivational and rewards and recognition efforts from ad hoc entertainment or payments that distort financial reporting.

SOX, in fact, has created an additional need for incentive and recognition programs to help draw organizational attention to new corporate standards of reporting. Many of the organizations most affected by the new statute have enormous employee audiences with whom the same marketing and promotional practices used for consumers

come into play. These include incentive and recognition programs that single out behaviors that support corporate values.

Proper program design and documentation can justify almost any noncash or motivational event with clear, research-based benefits, based on the dozens of research studies showing that such programs—those that fairly and equally recognize and reward people for the right actions and outcomes—have a significant impact on the bottom line and shareholder return. ■

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