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## Scan Based Trading Relationships

## SCAN BASED TRADING RELATIONSHIPS

The following paper has been developed by CMG's executive management team to communicate our position on scan based trading ("SBT") relationships. It is intended to be a vehicle to open new discussions and begin working to drive both short-term and long-term financial and operational change. CMG looks forward to your comments and partnership in bringing these discussions to clear, concise and, most importantly, achievable results. The contents of this paper were discussed and documented in the Fall of 2000 and, as such, we also maintain a "current company position" which is updated periodically, as needed, based on current events regarding the subject matter.

As you will note, our position herein regarding SBT is one of thoughtful planning, testing and implementation with emphasis on *systems, data synchronization, processes, internal controls and monitoring on an on-going basis*. CMG, though a privately owned joint venture, has focused on providing this same level of scrutiny to its own operations and, therefore, know that this approach will not only benefit each individual Company but it will benefit the supply chain as a whole. CMG not only undergoes regularly scheduled internal audits, we have also implemented Sarbanes Oxley and, as required by our publicly owned publishers that we represent, engaged a 3<sup>rd</sup> party to perform an internal controls examination in accordance with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70 (SAS70) Type II, Reports on Processing of Transactions by Service Organizations.



### ***Where we see the future ...***

Michael Novac once wrote, "The most dangerous time in the life of nations is the time between systems – when the old ways are discredited, but the new habits and institutions have not yet taken shape." CMG would be remiss in this communication if the obvious were not stated: "Newsstand distribution is broken and needs to be fixed." As a Company, CMG positions itself as an industry leader to strategize and work with the channel to develop new programs that are thoughtful and achievable in the short and long terms. Most importantly, they are programs that yield results to continuously improve the "broken model" by focusing on the point of sale and opportunities within the supply chain to gain efficiencies. The future will be radically different than today and it will clearly impact and promote more partnering among all members of the supply chain.

As previous and current studies have communicated, a truly viable option for optimizing efficiencies within the distribution channel for magazines is SBT. CMG is currently participating in numerous industry initiatives and strategizing internally as to how CMG will recommend and achieve new trading dynamics for a paperless and more efficient environment (which may include SBT). CMG believes that SBT will change the supply chain dynamics significantly, including roles and responsibilities, as the relationship between manufacturer and retailer becomes increasingly important. There are several designs that could potentially evolve. For example, the new economic model might include a direct payment relationship between the retailer and the

manufacturer (publisher and/or their sales & marketing representative). At this point, the functional services within the supply chain would be unbundled and a new financial model, which still promotes magazine sales, would evolve for the operational mechanics of the supply chain. Alternatively, certain retailers will want to take on an even larger role in performing these unbundled services themselves. As a result, the industry could then concentrate efforts on sales and marketing at checkout and mainlines along with management of the category to optimize sales across all chains in all channels. Though there are many ways the distribution channel might evolve, there is one common theme that is apparent. The supply chain must be *flexible and adaptable* to the retailer requirements for magazine fulfillment and reconciliation of transactions.

In regards to SBT, the benefits are numerous; however, they are not realized without overcoming some challenges for the magazine category. While some business relationships will qualify for SBT, there will be some that do not qualify due to financial, operational or systematic challenges where a partner is unable or unwilling to change. As such, CMG's approach was to build from the top down and identify where the inherent risks are and, subsequently, determine acceptable and unacceptable business terms for SBT relationships as identified by CMG. Please reference our risk analysis in Attachment I.

### ***Our Recommended Approach ...***

As noted above, our position herein regarding SBT is one of thoughtful planning, testing and implementation with emphasis on *systems, data synchronization, processes, internal controls and monitoring on an on-going basis*. We have proven that partnering within the supply chain to plan and test new programs, such as SBT, has led to more effective positioning of these Programs to gain the most benefit for all channel partners. As such, our position herein for SBT focuses on a phased in approach overviewed as follows:



Phase I focuses on discussing and setting up the basic processes and systems that will support the SBT protocol agreement.

#### ***Phase I – Parallel Test emphasizing Operational and System Integrity***

##### **Primary Goals:**

1. Create a parallel system whereby point of sale ("POS") data can be compared to the current distribution systems.
2. Create audit reports that measure the discrepancies in reported sales between the systems to identify sources of shrink.
3. Consider the identification and support of an industry facilitator for exchanging data (including UPC / GTIN data).
4. Provide recommendations for operational and system controls which address items such as issue code identification, updates to item files (UPC / GTIN data), future shrink monitoring and allocation, check-in procedures, check-out procedures and destruction of returns.

5. Engage a 3<sup>rd</sup> party auditor to perform an independent attestation review of the internal controls environment. CMG and its representative publishers request that this examination consider or be performed in accordance with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70 (SAS70) Type II, Reports on Processing of Transactions by Service Organizations. This requirement is also strongly recommended and supported by our 3<sup>rd</sup> party auditor, and many of our publishers 3<sup>rd</sup> party auditors.

For additional details on auditing, please reference [Attachment II – Example Audit Work Program for Magazine Shrink Analysis](#). For detailed technical requirements on data feed requirements, please reference [Attachment III](#) and [Attachment IV](#).

Note: During this phase, CMG will **not** change the financial terms with the wholesaler and will see that appropriate controls are in place to ensure that shrink levels are not posted as return claims, which would be a violation of CMG's return affidavit policy. This includes a requirement that CMG receive directly 12 months of POS data for the category from the respective Retailer and the same 12 month period of order regulation data from the wholesaler to perform #1 and #2 above.

### Phase II - Scan Based Trading including Pay from Scan

Once an appropriate level of testing has been performed and agreed to by the involved parties, it is then plausible to move into an SBT relationship. CMG recognizes that, for each relationship, there could potentially be different roles & responsibilities and the future is unclear, to date, as to how those will evolve. As such, the protocol agreement(s) will be the driver to defining the new relationship. With that said, we would also include the following goals during this phase:

#### Primary Goals:

1. Implement new system and operational procedures and controls for removing inefficiencies from check in, check out, handling returns, replenishment, etc.
2. Implement a paperless environment through electronic data exchanges and automatic payments and reconciliation of sales.
3. Implement a new financial model as agreed upon in the respective protocol agreement(s).
4. Create new or enhanced roles and responsibilities (for CMG and wholesalers) including service level expectations and metrics for evaluating performance.
5. Implement a procedure whereby shrink can continue to be monitored (audited) on a sample basis, extrapolated to the entire chain and then allocated based on a protocol agreement. This would include terms, which would allow a chain to lose SBT privileges for continued non-compliance of committed controls. See Attachment II for an example audit work program.
6. Perform annual independent attestation reviews of the internal controls environment. CMG and its representative publishers request that this examination consider or be performed in accordance with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70 (SAS70) Type II, Reports on Processing of Transactions by Service Organizations. This requirement is also strongly recommended and supported by our 3<sup>rd</sup> party auditor, and many of our publishers 3<sup>rd</sup> party auditors.

These two distinct stages will allow the industry to "transform" in a reasonably controlled manner. Though CMG views these as distinct stages, at any given point in time, different partnerships will be transitioning into the various stages at their own pace. In addition, as CMG learns more in these partnering relationships, it is anticipated that the diversity in backgrounds and objectives of other partners, as well as overall results, will lead to even more pronounced change for future improvement of product delivery and category management. After all, we're all in business to sell to the end consumer.

## **CMG Risk Evaluation**

How does the industry move to new levels of supply chain dynamics?

*In the area of SBT, CMG is participating in numerous industry initiatives which have allowed us to put together an internal task force and protocol considerations (trading practices between business partners) for recommended preferred, acceptable and unacceptable SBT terms.* This includes technology requirements, operational procedures, performance metrics, terms of financial arrangements and overall roles and responsibilities for each model. In these efforts, CMG has brought together fair and reasonable business practices for the level of risk associated with the various models that have been introduced thus far in the industry tests. *While CMG believes that SBT will and should be part of our future, it is leading the efforts in a conservative manner to ensure that the industry builds the infrastructure necessary to support these models. [See cover letter for references to current CMG position\(s\).](#)*

See [Attachment I](#) which contains our preferred, required and unacceptable recommendations for discussion and possible inclusion in a protocol agreement.

In each test that CMG has been involved in thus far, it has required that the areas covered in our risk evaluation (noted in Attachment I) be addressed to more effectively monitor the test and, more importantly, to create benchmarks for the new trading relationship. The majority of tests thus far have proven several points:

1. Testing is necessary.
2. Rushing the test only leads to “bad data” and not enough assurance on readiness of the program.
3. Benchmarks will need to be established to address hurdles related to issue identification, galley product, handling of unsold magazines and quantity and quality of data exchange.
4. Centralized repository for exchange of data (i.e., UPC information and exchange of POS data) should be evaluated.
5. Protocol agreements for entering into a new relationship will be necessary.

## **Conclusion**



CMG embraces the future with cautious optimism. While CMG is willing to participate in and influence SBT practices for our category, it also recognizes the importance and magnitude of the change that will be required. As a result, CMG with its channel business partners wants to monitor, in a controlled manner, the effects of SBT on the financial, operational and technological aspects amongst all its business partners.