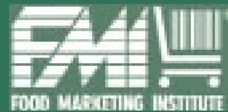
ADJUSTABLE RATE POLICIES

AN UNSALEABLES WHITE PAPER



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Adjustable Rate Policies —
An Unsaleables White Paper

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It should be noted that this white paper does not intend to endorse or recommend adjustable rate policies for manufacturers. The interpretation of the success of such policies varies greatly amongst individual trading partners.

Background

Prior to 1980, manufacturers picked up retail unsaleable product at the store-level. As manufacturers began to streamline sales forces, this process became too labor intensive, time-consuming and costly for the manufacturer community. Beginning in the 1980's, several reclamation centers were created to handle the flow and management of unsaleables products. In 1990, manufacturers and distributors worked together to create guidelines for the management, reimbursement and shared responsibility factors of unsaleables and reclamation centers, known as Product Reclamation Centers – A Joint Industry Report (JIR) in 1990. As centralized reclamation became the norm for unsaleables processing in the industry, the number of reclamation centers exploded in the mid-1990s, growing by 40 percent from 1992 to 1997. And while the centers were an efficient consolidator of unsaleables, both in calculating retailer reimbursement and the disposal of product, the industry began to see a steady increase in the amount of unsaleables.

According to the industry's annual benchmark report, the unsaleables rate increased by 48 percent from 1994 to 2001. During that time, the rate grew each year — climbing from .75 percent of sales in 1994 to 1.14 percent of sales in 2001. The total unsaleables cost in 2001 for warehouse-delivered food and grocery products was estimated at $2.5 billion.

With the additional visibility and tracking of unsaleables data, and the amount of product now flowing through the reverse supply chain via reclamation centers, it is not surprising that the published rate of unsaleables has increased since the early 90's. Until the industry had the appropriate tracking tools, the amount of unsaleables had been underestimated.

Adjustable Rate Policies (ARPs)

It was against this backdrop that manufacturers developed a new approach to reduce their cost of unsaleables and further the principle of shared responsibility by implementing adjustable rate policies.

In general, these policies established unsaleables funds whereby the manufacturer agreed to reimburse a retailer based on a rate predetermined by the manufacturer. The rate often was based on historical unsaleables data collected by the manufacturer and/or third-party auditors and typically was expressed as a percentage of the manufacturer's sales to the retailer.

The goal of the new approach, from the manufacturer's perspective, was to gather more information as to what was creating unsaleables and ultimately to reduce their unsaleable costs. Most manufacturers conducted audits of the supply chain (e.g. plants, distribution centers and retail stores) that would assist in identifying root causes and controlling unsaleables expenses. As a result, more attention was paid to unsaleables and joint partnerships formed between retailers and manufacturers focusing on root causes and unsaleables reduction.

Differing Perspectives of Unsaleables

Prior to the inception of adjustable rate policies, a majority of manufacturers' unsaleables programs reimbursed distributors for all damaged or expired product at customer reclamation centers regardless of which party was responsible for its cause. As reclamation became the retailer's method of collecting store returns, discontinued items also started to flow through the reclamation centers. As a result, some manufacturers believed that retailers had no incentive to address internal supply chain processes that might contribute to a product becoming unsaleable. Conversely, many retailers

believed manufacturers should take full responsibility for a product from plant to consumer. Many of the decisions that have been made in the past by the manufacturer's sales staff and the retailer's procurement staff never considered the unsaleables aspect of the procuring process. Many manufacturer sales teams have incentives for sales without penalty for unsaleables. Most retailers have viewed this aspect of the business for the most part, to be the manufacturer's responsibility and have not implemented measurements or incentives to correct high returns and unsaleables for store management nor category management. Shared responsibility became difficult to define based on these differing perspectives.

The 1990 JIR established the idea of "shared responsibility" between retailer and manufacturer where supply chain analysis of the damage was to be mutually identified by each party. Understanding what "shared responsibility meant financially was difficult because trading partners never could fully define or agree on what "shared responsibility" encompassed. The vast majority of the damage/unsaleables costs were charged back to the manufacturer.

From a manufacturers perspective, adjustable rate policies allow manufacturers to address the differences in shared responsibility by providing a financial incentive to distributors to focus on and reduce unsaleables internally. According to one retailer's supply chain director, the programs have achieved their desired effect for them by creating greater focus and greater urgency in evaluating the total supply chain and in taking measures to have some meaningful impact on source and cost reduction.

"It's like anything else – no one is going to do anything about the issue until you feel some pain," said a manufacturer's supply chain manager.

Many retailers maintain that adjustable rate policies have not shown a reduction in unsaleables but have shown a reduction of unsaleables costs to the manufacturer and that they are being forced to lower margins without visible manufacturer support in correcting supply chain issues. Manufacturers contend that much work has been done in recent years to educate and change processes internally (such as packaging, shipments and even buying practices) and therefore have been able to reduce unsaleables throughout the supply chain.

Increasing Unsaleables Handling Costs

One issue surrounding unsaleables was the belief by many manufacturers that most retailers were profiting from their reclamation centers by inflating item-handling charges. Trading partners would often disagree on what the true costs were for handling unsaleables through the supply chain as well as on which fees were allowable per the 1990 JIR on the handling of reclamation product.

"Our goal is to make money by selling products not by returning them. We never want our return centers to end up losing money, but we operate them to break-even."— retailer

Retailers, on the other hand, due to accounting differences, offer that while some centers are not managed as a break-even business, actual profits are non-existent, because the total supply chain handling-costs are not captured.

Manufacturers' Role in Rate Escalation

Meanwhile, some retailers contend that manufacturers contribute to the rise in unsaleables. Retailers state that the reason reclamation centers flourish is because manufacturers are not attending to damaged product at retail. There may also be a connection to an increase in new items introduced and the amount of discontinued product flowing through reclamation. One distributor explains:

"Representatives stopped coming to stores to give credit for damage. We would spend hours on the phone with brokers and manufacturers trying to get someone to come and pick (the product)

up. They didn't, and we would end up eating the cost. Then, with reclamation centers, manufacturers began eating it."

Retailers also cite declines in product packaging quality (reducing cost of packaging) that lead to increasing damage.

As a result, retailers note that some product packaging fails even under normal customer handling. Due to the complexity of collecting this data, however, the magnitude of this problem is never quantified. Nevertheless, some manufacturers acknowledge the claim's validity.

> **"An easy way for manufacturers to cut costs** is to lessen packaging quality, which results in poorly designed product for customer flow-through. It happens." – manufacturer logistics manager

Lastly, some retailers say they are not receiving product with sufficient shelf life to make it through their supply chain before going out-of-date and becoming unsaleable. Manufacturer's objectives to increase run sizes and reduce the number of run times to create manufacturing efficiencies can shorten the life of inventories and contribute to product expiration prior to consumer purchase.

Adjustable Rate Policy Consequences

Most distributors and manufacturers agree that the development of adjustable rate policies has created a renewed focus on reducing unsaleables across the industry. In addition, many retailers and manufacturers agree that adjustable rate policies have strained buyer and seller relationships. This new approach has not been implemented without consequences for both parties, however.

Among the most pervasive difficulties are issues surrounding merchandising, product disposition and unsaleables data capture and analysis.

Merchandising Effects

Prior to the implementation of adjustable rate policies, the merchandising function at most retailers paid little attention to unsaleables — except as it related to private-label manufacturers that historically have had stringent return policies. Rarely, if ever, were the level and the risk of unsaleables criteria considered in new item or promotion decisions. Further, reclamation activities typically were handled autonomously by the logistics function and little, if any, data was shared between the two groups.

> **"Category managers could care less** (about damage). Do they call me up and ask what the (unsaleables) rate is for this product or that product? Generally, no." – logistics manager

Adjustable rate policies have brought the two functions closer at many distributors, as many manufacturer programs link both merchandising and unsaleables funding — both explicitly and implicitly. For example, in some programs if a retailer exceeds its unsaleables funding, the manufacturer takes the overage from the retailer's merchandising funds. Alternately, in programs in which the manufacturer separates the funding, the retailer often co-mingles the funds internally to offset any unsaleables shortfalls. The net result is that some retailer merchandisers or category managers ultimately have become accountable for unsaleables for certain manufacturers.

As a result, some category managers have begun examining new items and promotional plans with the objective of determining their likely effect on unsaleables. While this scrutiny has helped prevent some products from becoming unsaleable, it also has strained some retailer-manufacturer relationships. One manufacturer explains:

"There have been occasions where retailers have denied new item authorizations and promotions (because of adjustable rate policy disputes). And there have been demands for more shelf life — more than you could possibly give them based on the distribution network."

Many retailers believe this is standard operating procedure to expect these types of requirements to understand more fully the overall effects on the total supply chain.

Product Disposition

A benefit of most non-adjustable rate policies to manufacturers is that they were able to stipulate how distributors disposed of unsaleable product. Consequently, a majority of unsaleable product is destroyed or donated to food banks. By maintaining this control, manufacturers can protect a brand's image by ensuring that no damaged or out-of-date products are sold to tertiary markets and then to consumers.

This authority was relinquished with the implementation of adjustable rate policies as manufacturers no longer effectively "bought" the unsaleable product back from distributors. The distributor now maintains ownership or "title" to dispose of the product within the distributor protocols. Some manufacturers believe there may be a rise in secondary and tertiary market sales.

Meanwhile, there has been a decline in some food bank donations from retailers and reclamation centers since adjustable rate programs were implemented. For example, overall local donations to America's Second Harvest's member affiliates and agencies have remained flat over the past three years. In some areas of the United States donations have decreased. This change places a heavy burden on some locations to support their growing need and challenges the national office of America's Second Harvest to raise more food and grocery donations to feed the nation's hungry.

The reason for this reduction in donations can be attributed to two schools fo thought since the reimbursement on unsaleables are capped, 1) the manufacturer no longer "owning" the product allows the distributor to resell the product to tertiary markets in an attempt to offset losses in margins and, 2) retailers are now focusing at retail level to ensure "saleable" product is not sent to reclaim but instead sold through the store. Prior to the inception of adjustable rate policies, retailers may not have taken the time to sort though cases removing the good product and sending only the unsaleables to reclamation. Additionally, the industry is focusing more on better management of discontinued products and processes through collaborative work. This also has decreased the amount of product flowing through reclamation and ultimately to food banks.

"Last year we donated 624 trailers, and this year we donated 100 less. That's a lot of product and the reason it happened is that our reclamation centers aren't getting as much product back from the stores." – retailer logistics manager

"A lot of product that used to go back to reclaim is sitting in markdown baskets out in stores.
– retailer supply chain manager

Many retailers acknowledge that, since the new unsaleables policies have been in place, their donations to feeding programs have declined.

Unsaleables Data

Most manufacturers and distributors agree that one of the key enablers to identifying and eliminating the root causes of unsaleables is data. It is necessary to have this data by category and product type, not just from a third party.

Some retailers fear that adjustable rate policies will result in a loss of data, since manufacturers streamline costs and focus primarily on capturing internal damage information. Supporting this apprehension, some retailers indicate that, since the implementation of the new programs, several manufacturers no longer purchase any reclamation center data, nor do they perform any retail damage inspections. Alternately, these policies have spurred other manufacturers to join with their retail partners in detailed total supply chain audits to determine unsaleables causes.

Additionally, some distributors believe that the new programs will force retailers to give up capturing their unsaleables data in order to save the expense, especially in situations where the manufacturer funding is less than the retailer's unsaleables rate. As a result, retailers that could benefit the most from capturing and analyzing unsaleables data may have the greatest incentive not to collect it.

Case Study 1

Manufacturer A

Adjustable Rate Policy Example

Background

Manufacturer A implemented an adjustable rate program in 1997. The program was part of a larger initiative, which aimed to address industry inefficiencies in replenishment, new item introduction and product promotion.

Manufacturer A believed that the only way of achieving this goal was for their retail partners to share responsibility for unsaleables by bearing some of their cost. Both retailers and manufacturers had agreed to the concept of shared responsibility in principle years earlier, but it had never been implemented.

In addition, Manufacturer A determined that an adjustable rate policy would greatly simplify the company's unsaleables administration vs. their existing program. That existing program was indeed complex with:

- Seven payment options
- Eighteen million inspected items
- 8,700 inspections
- 36,000 customer claims

Finally, the existing program had created conflict between Manufacturer A and retailers as disputed inspection claims frequently resulted in retailer invoice deductions.

Development and Implementation

While transition to the program and the adjustable rate approach was completed in 1997, Manufacturer A's development plan began with a twelve-month auditing program of the entire supply chain. The purpose of the audits was to determine for what percentage of damaged product Manufacturer A was responsible and to identify opportunity areas for damage reduction in Manufacturer A's packaging and shipping processes.

Using the audit data, Manufacturer A determined that it was responsible for 70 percent of unsaleable product, and, therefore, the new program would reflect this rate. Consequently, the adjustable rate policy would reduce Manufacturer A's unsaleables funding by 30 percent from existing levels.

In order to give distributors time to adjust to the new policy, payments for the first year of the program (1997) were based on historical funding levels vs. the reduced audit-based rate. During the first year, actual damage data were closely monitored, and Manufacturer A offered customers field resources to help identify unsaleables opportunities. Further, the rate was reduced to only 85 percent of historical levels in the second year and finally to 70 percent in the third year.

To maintain an accurate rate for the program, Manufacturer A annually audits a statistically significant sample of 1.5 million selling units. Seventy-five percent of these audits are done at customer dis-

tribution centers, and the balance is completed at Manufacturer A sites after simulating customer shipping and handling. Internal audits are performed due to inventory and receiving constraints at customers. Based on the annual audit data, Manufacturer A has increased and decreased the LDI rate during the first five years of the program.

Policy Issues

The new program has sparked controversy with some customers, especially with distributors whose unsaleables funding was drastically cut while their unsaleables rate has remained constant or has increased. In response, some retailers have funded these deficits with Manufacturer A's merchandising funds while others have delayed new item introductions on the basis of potentially high damage rates.

In addition, survey information shows that the implementation of new policy may have caused higher tertiary market sales of Manufacturer A products. Audit data reveal that during the first two years of the program, the percentage of tertiary market stores selling at least one Manufacturer A product rose by more than 30 percent from 70 percent of stores to close to 95 percent. Meanwhile, customer donations of Manufacturer A product to food banks have declined during the last three years.

Future

Despite the issues, Manufacturer A considers the program to be a success — not only as a cost-savings vehicle but also as a catalyst for the industry to attack the root causes of unsaleables throughout the entire supply chain.

And while Manufacturer A faces challenges in extending the program to new product lines (e.g., to incorporate return guidelines for appliance-type products), no plans exist to drastically alter the current adjustable rate policy in the near future.

Case Study 2

Retailer A

One Retailer's Response to Adjustable Rate Policies

While the number of manufacturers that have implemented adjustable rate unsaleables polices is still relatively small, the impact of the policies has been sufficient enough for many retailers to make substantial internal changes in order to reduce unsaleables even without the benefit of manufacturer assistance. For one such retailer, Retailer A, adjustable rate policies have been the catalyst for changes to internal data systems, supply chain processes and retail incentives.

Data Systems

Prior to the implementation of adjustable rate programs, unsaleables data were analyzed almost exclusively by manufacturers, who paid for third-party vendors to capture the information at customer stores and reclamation centers. Manufacturers used this information to identify and correct packaging and supply chain process failures. Retailers had access to the data, but their system capabilities were limited. Most provided only the information necessary to bill manufacturers for reimbursement and to credit individual stores.

The result was that many retailers did not have systems in place to properly monitor unsaleables when adjustable rate policies were introduced in 1997. Retailer A was no exception. Consequently, one of Retailer A's initial changes involved creating a system that would allow them to access and analyze unsaleables information at the category, vendor and U.P.C. level.

Retailer A's reverse distribution coordinator describes the software: "What we have is modeled after our front-end system. It allows us to pull unsaleables just like Nielsen data, and everyone in the company has access to it."

With this new system, Retailer A can track whether actual unsaleables costs are greater or less than manufacturer funding. Further, the real-time access (data are updated monthly) allows supply chain managers to identify and attend to potential problems quickly. For example, if the data show a dramatic rise in the damage rate of a particular UPC, supply chain coordinators "flag" the item for the third-party reclamation center handlers. The handlers then hold any returned product of this item instead of destroying or donating it. That way, Retailer A's logistics managers can examine the returns to identify any global failures that might be the cause of the rise in damage, allowing the issue to be quickly addressed internally or with the manufacturer.

Retailer A acknowledges that the quality of the data could be improved. It is too costly to capture and categorize the data by damage type at present. However, the current information and upgraded system have been key tools for the retailer to reduce unsaleables.

Supply Chain Processes

Retailer A also altered its receiving and damage-handling processes in response to the new policies. On the receiving end, Retailer A began more detailed inspection of deliveries and refuses any incoming damaged product. Further, receiving dockworkers are equipped with digital cameras so that they can photograph any damaged loads. Logistics managers then review these images to identify possible damage causes like poor pallet fit, wrapping or layering. Then they work to resolve these causes with manufacturers.

Additionally, Retailer A has made changes to its damage-handling processes. Prior to adjustable rate policies, entire cases would be destroyed or donated with little inspection. Today each one is carefully examined to determine whether some of the individual items within the case are still saleable. If they are, that product is sent back to stores and the balance is disposed of.

Importantly, while these changes were made in response to the new damage programs, the processes are not limited to those manufacturers with adjustable rate policies. Thus, the institution of these procedures has served to reduce the unsaleables rate across all manufacturers. And while Retailer A has not yet performed any cost-benefit analysis on these new labor-intensive practices, logistics managers are confident that the investment makes sense.

Retail Incentives

According to Retailer A's reverse distribution manager, the program with the most significant impact on unsaleables has been the revision to the way stores are credited for damaged product.

Under the old program, stores were credited by Retailer A's headquarters for 100 percent of the cost of any damaged product sent to reclamation. This arrangement provided little motivation for retail personnel to minimize damage and became untenable when adjustable rate policies stopped reimbursing the headquarters for the full cost of product.

Retailer A's solution was to create an incentive for stores to reduce their damage by giving each a by-department damage allowance. In essence, the program mirrors the manufacturers' adjustable rate policies. The way it works is that any product that the store sends to reclaim is credited against the allowance. If the aggregate cost of the product sent to reclaim exceeds the allowance, the store pays for the overage. Alternately, if the total cost is less than the allowance, the store keeps the difference.

A Retailer A supply chain manager explains the impact of the program at retail: "At first there was a negative reaction at retail. But now the allowance has become a tremendous incentive for the stores to focus on improving practices to reduce damage. Store managers are rewarded extra bonuses based on the profitability of their store, so if they have too much damage it cuts into their budgeted shrink number. With more damage they take the risk of not getting additional bonuses at the end of each quarter."

Since the allowance covers all products vs. just those covered by adjustable rate programs, Retailer A's supply chain managers credit the change with a substantial reduction in total damage at retail. In the initial six-month pilot program, which covered dry grocery goods, damage sent to reclaim from stores declined by 15 percent.

Retailer A acknowledges that a risk of the allowance program is the potential for stores to sell more damaged product to beat their allowance budget. However, this behavior has not been observed to date.

Next Steps

Retailer A is working to incorporate damage data into an activity based cost model for all items. With this model, buyers will be able to determine the true impact of product damage rates and manufacturer funding. In the meantime, supply chain managers hope to enroll the merchandising department to help reduce damages further.

A logistics manager explains, “It used to be that buyers would say, ‘How can you hold me accountable for damage when the stores still get 100 percent reimbursement?’ Now that that is no longer the case, we need help on the buying side.”

Case Study 3

A Retailer's Approach to Unsaleables Reduction with One Manufacturer

Background

The following describes actions a retailer initiated with a manufacturer to help reduce unsaleables. A substantial gap currently exists between the manufacturer's standard allowance rate and the retailer's calculation of its actual damage. As a result, Retailer Y suggested that Manufacturer X spend nine months working in partnership to reduce unsaleables across their supply chain.

The first step in this partnership was to assemble a cross-functional team from both companies to narrow the unsaleables and allowance gap. From Manufacturer X, the team includes a sales manager, logistics manager, packaging and development manager, retail service manager, customer service manager, distribution center manager, and marketing and development manager.

From Retailer Y, the team includes a supply chain manager, retail sales coordinator, division merchandiser, warehouse superintendent and distribution manager.

The process involves six key steps:

1. Audit of Manufacturer X's plant and DCs that service Retailer Y to examine "loading for customers" practices and storage handling.
2. Audit of three of Retailer Y's DCs to examine unloading practices, condition of product in DC and slots.
3. Audit of Retailer Y's reclaim center for Manufacturer X's items and conditions.
4. Audit of 15 retail stores per DC.
5. Third party hidden damage assessment.
6. Preparation of an executive summary by manufacturer's audit professional to review data collected and presentation to senior management at both companies

Their experience highlights the difficulties of quantifying shared responsibility and implementing specific measures to reduce unsaleables, but it also represents an approach that can produce measurable results over time.

Adjustable Rate Development and Policy

Manufacturer X engaged a third-party unsaleables vendor to conduct a 16-month, extensive study of hidden damage. More than 300,000 consumer units, as well as corresponding consumer unit loads and case trays, were inspected in customer DC pick slots across all channels of trade. During the course of this initiative, Manufacturer X attempted to identify internal root causes for unsaleables and take steps to reduce them (e.g., packaging integrity, quality audits at plants and DCs, use of auto-pick and auto-load software, and increased dating of delivered product to 50 percent of consumer shelf-life).

Manufacturer X used the audit data to compute an adjustable rate based on three components:

1. An actual damage rate by product category in customer DC pick slots as determined by third party audits.

2. A handling fee reimbursement based on Manufacturer X's current joint industry recommendations policy.
3. An additional allowance for Manufacturer X's shared responsibility for unsaleables related to expenses arising from customer discontinued items, oversell/overbuy, expired product, miscellaneous items (such as pilferage due to on-pack and in-pack promotions) and consumer damages. With this allowance, Manufacturer X has assumed responsibility for 50 percent of all unsaleables above the combined damage/handling rate.

The individual components and total rate are subject to revision annually based on the findings of continuous audits by the third party.

Under the plan, Manufacturer X will provide retailers a minimum of three month's advance notice for discontinued items, enabling the retailers to reduce prices to avoid product becoming out-of-date or being sent to reclaim. Manufacturer X is responsible for picking up all full, unopened cases of any manufacturer discontinued item regardless of remaining shelf life and will issue special markdown funds to sell through product on the retail shelf. The manufacturer will also pick up any full, unopened cases of product discontinued by the retailer provided they have 25 percent of code life remaining.

Overage, shortage and damaged goods received upon delivery and seasonal items are excluded from the program.

Policy Issues

The critical issue for Manufacturer X is that approximately one-half of its customers currently face a shortfall between their adjustable rate for 2003 and their actual reimbursement from Manufacturer X in 2001. As a result, many of these customers dispute the calculations used to determine the individual components of the rate. Furthermore, these retailers fear that the rate may change over time based on revisions to the damage rate and the 50 percent shared responsibility allowance components.

The detailed audits from the collaborative implementation process with Retailer Y have revealed specific opportunities to reduce unsaleables (e.g., packaging improvements, open-code dating, and inventory management practices in the customer DCs, shelf rotation in the retail stores). However, as the two parties undertake the audits, their views on their ability to take proactive measures to reduce unsaleables differ, despite the fact that they do trust one another as individuals. Supply chain managers at Retailer Y, for example, have been frustrated by Manufacturer X's refusal to strengthen packaging for specific items, asking:

"We are on this project to work to reduce unsaleables across the whole supply chain. If you as a company are serious about reducing unsaleables, we should see more of an effort to do so on issues such as packaging. We don't want you to do this just so your company can say you worked with us to make us feel good. If that is the case, we do not need to waste each others' time."

The Future

These two trading partners expect to complete the implementation process, and relations between the individual members of the team remain healthy. However, it is likely that the gap will not disappear before January 1, 2003, and each side thinks the other can do more internally to reduce unsaleables. Friction inhibits their trading relationship, but they continue to find ways to discuss problems, attempt to solve those problems and use information to make solutions contractually binding.

Case Study 4

A Different Approach: One Manufacturer's Efforts to Reduce Unsaleables Without An Adjustable Rate Policy

Background

Manufacturer B has decided to focus on addressing the root causes of unsaleables to reduce expenses across the supply chain instead of implementing an adjustable rate program. In 1998, "unsaleables reached a level where they were painful" for this manufacturer. Its rates were well above the industry average after climbing steadily throughout the decade of the 1990s.

As a result, Manufacturer B appointed one individual to take company-wide responsibility for reducing the volume of unsaleables. Prior to 1998, Manufacturer B did not make any attempt to manage the unsaleables problem and customers "did whatever they wanted."

Strategically, this manufacturer has decided to avoid adjustable rate programs because of potential unintended consequences (e.g., higher tertiary market sales, consumer purchases of damaged product, etc.) and the potential impact of these factors on the integrity of the brand. However, this manufacturer has worked aggressively internally and externally to address root causes. Through specific actions, Manufacturer B reduced unsaleables volume by more than 25 percent within one year and has since managed to hold unsaleables expenses at the same level.

Specific Actions

Discontinued Items: Manufacturer B assumes total responsibility for taking full cases out of customer DCs. Depending on the product, it may then be transferred into a pre-selected close-out market, shipped back to the manufacturer's DC or donated to America's Second Harvest. "We understand that new item launches are the lifeblood of the consumer business, and discontinued items are a fact of doing business," a company spokesman said.

Promotions: Manufacturer B's sales force works closely with customers to prevent overbuying by analyzing historical data and devising a mark-down sell-through strategy. Also, when marketing managers budget promotional dollars, they factor in the cost of unsaleables.

Packaging: After collecting data from trace studies conducted by Universal Solutions, Manufacturer B made certain packaging changes. While Manufacturer B has not conducted extensive cost/benefit analysis for packaging, individual managers do ask themselves internally: "What effect does a $500,000 savings in packaging production have on unsaleables expenses?"

Logistics: Manufacturer B charged its logistics team with working with retailers to develop standards for pallet sizes. In 1998, teams found some pallet sizes were too tall, and pallet sizes were adjusted accordingly. "We want to eliminate the number of touches on our product through the supply chain," a team member said.

Analysis: The manufacturer uses third-party as well as internal data to proactively identify exceptional trends and then understand root causes, which is an ongoing process. For example, if the return rate for a particular product from a particular customer DC spikes, the unsaleables manager for Manufacturer B picks up the phone or visits the customer DC to solve the problem.

Assessment

Using this approach, Manufacturer B has achieved success because of the degree to which the actions are coordinated internally among the relevant departments and externally with customers. The internal coordination would not have occurred without senior-level management focus on the unsaleables problem and the inclusion of unsaleables expenses within bonus calculations for sales, marketing and other professionals.

As a result, Manufacturer B has aligned incentives with the stated objective of reducing unsaleables costs.

Solving Unsaleables Issues

Unquestionably, differing points of view complicate matters in any commercial relationship as each side is sensitive to bargaining power, to cutting the best deal and to making sure the other side does not gain some advantage from the situation. Friction between trading partners about costs and how they are distributed is not a new phenomenon, nor is it a phenomenon unique to the grocery industry (witness the recent friction between Ford and Firestone). "Behavioral" or "organizational" issues often make implementing change in supply chains difficult.

Furthermore, conflicting incentives perpetuate these behavioral issues. A marketing manager tends to focus on the urgent pressures affecting his or her work in new product introductions (such as increasing sales). A production manager tends to focus on manufacturing costs but may not factor in how reduced packaging costs may result in the unintended consequence of actually increasing costs because of damaged product.

Supply chain management compounds these behavioral issues, because it involves managing processes across organization and company boundaries where incentive alignment becomes even harder to achieve. Not only does a marketing manager focus on developing innovative new products, but also in his or her view, the customer may be responsible for inaccurate demand forecasting. For the production manager, why should he or she invest in more durable packaging when the retailer is obliged to handle the product carefully to avoid damage?

It is no surprise that unsaleables expenses across the supply chain rose steadily without adjustable rate policies. It also is no surprise that manufacturers and retailers will disagree on issues like shared responsibility, data integrity, packaging quality, questionable buying and selling practices, underlying motivations behind terms of sale and doubts about their respective commitment to creating a "win-win" situation.

Unfortunately, incentives and behavioral issues make such dispassionate approaches difficult and make solving issues like unsaleables a complex endeavor.

Acknowledging this, are adjustable rate policies an effective solution to the unsaleables issue?

While there is no definitive answer, the development and implementation of these policies have been a catalyst for both manufacturers and retailers to devote greater resources to addressing the root causes of unsaleables. The measure of success will be whether these efforts translate into a decline in unsaleables across the industry.

Several lessons can be drawn from the current adjustable rate policy development and implementations. Among them are:

- Coordinated, cross-functional oversight for policy development, implementation and maintenance is better than working within functional silos.
- Significant adjustable rate policy implementation lead-time helps to reduce trading partner friction and allows parties to take constructive steps toward reducing unsaleables.
- Senior management commitment, engagement and education are critical.
- Data collection and analysis empower managers to make the right decisions about unsaleables issues. Activity based costing is a particularly useful tool in aligning incentives and making informed evaluations.
- Aligning store and category management incentives with the goal of reducing unsaleables expenses modifies behavior in a constructive manner.

- On-going measurement and communication help reduce friction and expenses as well as encourage education about the problem of unsaleables.

The lessons drawn and the successful practices outlined in this white paper are general in nature. A successful practice or one scenario may well be ideal for one company and not fit another, depending on the particular circumstances.

Many of the specific measures in the case studies included in this report are contract-based (e.g., an actual adjustable rate), information-based (e.g., an audit to identify sources of unsaleables or CPFR) and trust and relationship-based (e.g., coordinated work between manufacture and retailers on promotional decisions). Identifying what kind of measure would be most successful under different circumstances requires company knowledge and managerial judgment.

Is Manufacturer A's detailed audit and finding that it is responsible for 70 percent of the unsaleable product a better practice than Manufacturer X's decision to split the damage with its additional allowance? Is vendor-managed inventory a solution for poor buying and selling practices? It is difficult to answer these questions without understanding the product and channel mix, among many other factors.

In order to create "win-win" opportunities managers from manufacturers and retailers need to ask the simple question: How would my decisions be different if I were in my trading partner's shoes? Often, those answers are a function of particular incentives.

Conclusion

This white paper is intended to provide a background and broad examination of adjustable rate policies. The growth of these policies has initiated both positive change as well as tension among trading partners in the CPG industry. All of the benefits and drawbacks must be examined prior to a manufacturer shift to an adjustable rate policy. There are many questions to be raised when manufacturers are considering the implementation. Many of these questions have been mentioned in this paper through retailer perspectives and quotations.

There is a concern on the part of many retailers that more manufacturers will present adjustable rate policies without truly doing the necessary "homework" internally. The retail community has made it clear that new policies will not be accepted in the trade without manufacturer documentation of internal analysis, responsibility and proper lead time.

Retailers are also concerned that the manufacturers with ARPs will abandon the practice of unsaleables audits, data collection and will instead place the emphasis and priority on P&L, not unsaleables reduction. They are skeptical as to whether ARPs are truly reducing the amount of unsaleables in the industry or simply reducing the manufacturer's unsaleables costs. There exists also a potential sales impact to ARPs in that if the retailers costs go up, there is the possibility that the cost of goods to the consumer will increase as well.

The manufacturers that have rolled out ARPs feel it is an appropriate business strategy for their companies. They have used the new policy approach to initiate partnerships with key retailers to reduce unsaleables and improve supply chain processes. Manufacturers believe that this approach has also shifted unsaleables costs to a more reasonable sharing of responsibility between trading partners for the issue. Retailers are now placing greater focus on store-level unsaleables reduction which has been an important benefit to ARPs. The manufacturers also see the benefit in continuing supply chain audits and analysis of unsaleables in order to keep track of both unsaleables product as well as rate adjustments.

However, the success of ARPs has not yet been proven in the trade. Many of the policies are too new to be analyzed for success or failure. Therefore, no conclusions can be drawn on an industry-wide level as to whether ARPs will benefit the industry or simply shift the costs of managing unsaleables.

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