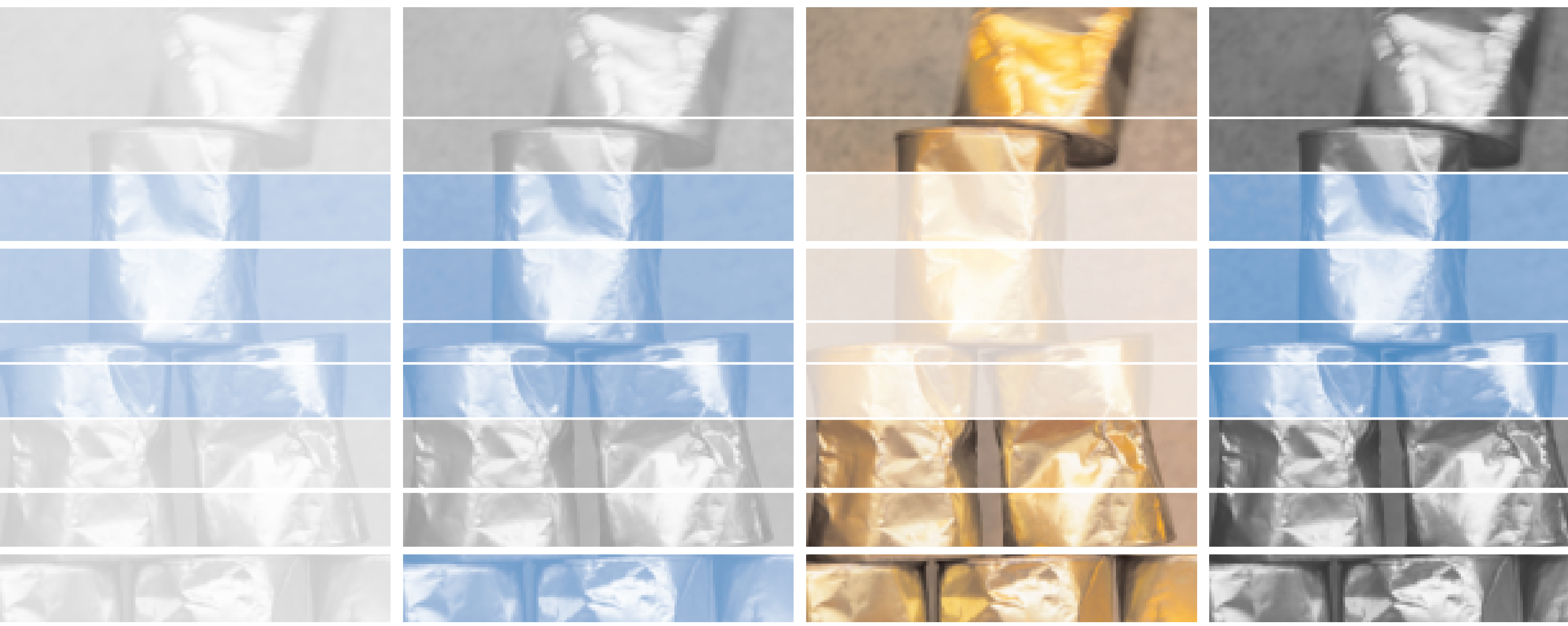
Improving Unsaleables Management Business Practices — *Joint Industry Recommendations*

November 2005



GMA
The Association of Food, Beverage and Consumer Products Companies

FMI
FOOD MARKETING INSTITUTE

R2N Raftery Resource Network, Inc.

FOOD MARKETING INSTITUTE

Food Marketing Institute (FMI) conducts programs in research, education, industry relations and public affairs on behalf of its 1,500 member companies — food retailers and wholesalers — in the United States and around the world. FMI's U.S. members operate approximately 26,000 retail food stores with a combined annual sales volume of $340 billion — three-quarters of all food retail store sales in the United States. FMI's retail membership is composed of large multi-store chains, regional firms and independent supermarkets. Its international membership includes 200 companies from 50 countries. For more information, visit the FMI Web site at www.fmi.org.

GMA
The Association of Food, Beverage and Consumer Products Companies

Grocery Manufacturers Association (GMA) represents the world's leading branded food, beverage and consumer products companies. Since 1908, GMA has been an advocate for its members on public policy issues and has championed initiatives to increase industrywide productivity and growth. GMA member companies employ more than 2.5 million workers in all 50 states and account for more than $680 billion in annual sales worldwide. GMA is led by a board of member company chief executives. For more information, visit the GMA Web site at www.gmabrands.com.

EXECUTIVE SUMMARY

This report addresses a difficult and complex topic — unsaleable products in the food and over-the-counter (OTC) drug supply chain. It arrives during the second decade of collaborative accomplishments among retailers, wholesalers, manufacturers and their respective trade associations in providing tools and recommendations for resolving business practice issues surrounding unsaleables.

The team that developed this report — the Unsaleables Leadership Task Force — observes that success in unsaleables management will ultimately accrue to trading partners that pro-actively work to identify and correct root causes of unsaleables through improved efficiencies and continuous dialogue that is constructive and progressive.

The intent of this report is to help trading partners focus on removing costs from the total supply chain, not merely shift costs from one trading partner to another. The general recommendation of the Unsaleables Leadership Task Force is that ***manufacturers and distributors should actively collaborate to fix root causes of unsaleables and equitably share the burden of unsaleables.***

The following task force recommendations are discussed in more detail in this report:

- **Individual trading partners should continue to use the voluntary guidelines and tools published in the 1990 "JIR"[1]** for efficient product reclamation along with the recommendations contained in this report which address today's key issues.
- **Industry leaders should consider the current role and implications of reclamation centers during top-to-top dialogues** so that manufacturers and distributors can move closer together on their understanding of how to improve efficiencies and reduce costs in the supply chain.
- **Individual manufacturers should consider both unsaleables policy methods — the JIR and the adjustable rate policy (ARP) methods** — in conducting their due diligence about most appropriate methods for use in their individual unsaleables policies.
- **All unsaleable products should be processed though reclamation centers** without regard for the type of manufacturer reimbursement method.
- **Manufacturers and distributors should collaborate on efforts to reduce the quantity of unsaleables** and repeatedly reinforce that collaborative strategy as a tangible mission in order to mitigate some of the conflict around unsaleables.
- **Trading partners should adopt a mission of total cost reduction** in addition to cost recovery in discussions that involve reimbursement for unsaleables costs.
- **Trading partners should use product condition data,** where possible, to identify opportunities to further investigate where and how the cause of product unsaleablity occurs in the supply chain.
- **Reclamation centers should be used for the efficient consolidation and control of non-damaged product** where mutually agreed-upon by trading partners.

[1] "Product Reclamation Centers: Joint Industry Report," 1990, FMI, GMA et al.

- Except for recalls, **products that should not be sent to reclamation centers include direct store delivery (DSD) and other products not distributed through the distributor's warehouse.**
- For temperature controlled products, **only clean, empty packages should be sent to reclamation centers; contents should be properly destroyed at the store.**
- **Hazardous materials from unsaleable products may be safely processed through reclamation centers** as long as special handling and labeling controls are practiced.
- **Product in saleable condition should remain in the store** for sale to the consumer.
- **Standards development organizations, e-commerce data pools and providers of related services and solutions should consider expanding their current data synchronization and registration initiatives** to include applicability for unsaleables data communications and synchronization.

Even if all of these recommendations become adopted in the industry, one critical issue could remain unresolved. ***Cost recovery for reclamation centers generally remains an unresolved major issue.*** At this time, the task force observes that ***the industry faces risks associated with declining funding for reclamation centers.***

After much investigation and debate, the Unsaleables Leadership Task Force concludes the following about reclamation centers:

- **Reclamation centers are currently the most efficient way to remove unsaleable products from the supply chain,** and they are viable tools for unsaleables management.
- **The negative implications to the supply chain if all reclamation centers ceased operations outweigh the positive implications.** Manufacturers and distributors would not be able to readily remove or recall damaged or otherwise compromised products from distribution in the supply chain and would lose centralized data for root cause corrections.
- **The reclamation center industry is in a consolidation phase, which will likely result in fewer processing facilities.** Some consolidation is driven by retailers and wholesalers; other factors such as mergers and acquisitions of companies that operate reclamation centers are also currently in play.

In summary, the supply chain has become dependent on reclamation centers within its infrastructure to efficiently process recalls and to improve store-level sanitation. These and other key functions provided by reclamation centers should remain in the collective consciousness of the industry. As long as unsaleables continue to exist in the supply chain, trading partners should deal with them in a responsible, fair and efficient manner.

INTRODUCTION

At the January 2005 mutual meeting of their boards of directors, the Food Marketing Institute (FMI) and Grocery Manufacturers Association (GMA) were instructed to charge their Joint Industry Unsaleables Steering Committee with revising existing guidelines for industry practices influencing the products that become unsaleables in the supply chain.

The FMI and GMA directors recognized current discord about unsaleables in the industry.

- Certain manufacturers and distributors have expressed the view that some of their trading partners do not behave fairly with regard to unsaleables.
- Each side wants the other side to be fair.
- Sales agents and wholesalers find it especially difficult to successfully collaborate with trading partners to control unsaleables costs.

The FMI and GMA directors further recognized that steadily rising levels of unsaleables costs serve as the backdrop for concern over diminishing industry interest to address the cost burden of unsaleables. Since the first industry benchmarks were published in 1995, the average reported rate of unsaleables has grown from 0.75 percent to 1.06 percent in 2004.

The FMI and GMA observe that the current industry climate around unsaleables resembles the climate that existed in 1989, when the first Joint Industry Unsaleables Committee was formed. That group published the "Joint Industry Report: Product Reclamation Centers in 1990."

The "JIR," as it has become known in the industry, has served as a template for business practices, unsaleable product handling and trading partner dialogues. It focused on the process of product reclamation and did not address the more complex subject of unsaleables management.

The associations' directors have charged the descendant committee for unsaleables initiatives with developing a new set of industry business practice guidelines for unsaleables product management and cost recovery, based on the 1990 JIR guidelines and principals and inclusive of the changes that have occurred in the reverse distribution supply chain since 1990. *On the advice of legal counsel, an update of the handling and operating cost study in the JIR was beyond the scope of this project.*

The Unsaleables Leadership Task Force was formed from the Joint Industry Unsaleables Steering Committee to work on this project. This report is the outcome of that project.

Definition of Unsaleables

For purposes of this report, unsaleables are defined as consumer products which are removed from the primary channel of distribution for any reason and which may or may not be processed through product reclamation centers. This definition has been used consistently in the annual industry benchmark surveys on unsaleables published for the food and over-the-counter (OTC) drug industries.

Terminology in the prescription drug and other consumer goods industries is somewhat different. For example, unsaleables are a subset of all returned goods in prescription drug reverse logistics; in food and OTC drug, unsaleables and returns are separate practices. This document focuses on the food and OTC drug practices associated with unsaleables. See “Returned Good Guidelines” published by the Healthcare Distribution Management Association (HDMA) for similar recommendations for the prescription drug supply chain.

Shared Responsibility Redefined

One of the key tenets of the 1990 JIR — the principle of “shared responsibility for unsaleables” — is addressed in this project. The principle itself is not in question, however, two distinctly different interpretations have evolved over the years. One focuses on collaborating to identify root causes of unsaleables; the other focuses on sharing the costs associated with unsaleables.

Trading partner collaboration on identifying root causes of unsaleables has become recognized as a viable method of applying the principle of shared responsibility. Financial collaboration has been less successful. *The Unsaleables Leadership Task Force recommends that manufacturers and distributors actively focus on both types of trading partner collaboration to successfully manage unsaleables quantities and costs.*

The Collaborative Group Process

The Unsaleables Leadership Task Force employed a process of group consensus development facilitated by FMI, GMA and a professional consultant with subject matter expertise. The multidimensional nature of the Unsaleables Leadership Task Force, combined with the volatility of the issues prevented this team from reaching 100 percent agreement on many of the statements and recommendations contained in this report.

However, all participants agreed to allow the group consensus to prevail over individual company positions in order to develop these guidelines. This is the same group process employed by the original 1990 JIR Committee. In other words, then as now, some company representatives respectfully disagreed with the general consensus of the group on aspects of the report.

The spirit of this successful group process is offered as an example to individual companies that are interested in taking action with trading partners following the recommendations in this report. The Unsaleables Leadership Task Force believes that collaborative “give-and-take” efforts between trading partners are needed to address the current industry issues surrounding unsaleables.

ASSESSING THE "JIR"

As part of its work, the Unsaleables Leadership Task Force evaluated the 1990 JIR in the context of current industry practices and issues. The task force was asked to pay particular attention to subjects that are not covered in the 1990 JIR and to voluntary guidelines from 1990 that may no longer be appropriate.

In general, the 1990 JIR contains valuable information about the product reclamation process. It remains a valid source of guidelines for operating a reclamation center and provides several tools for managing unsaleables.

However, it does not contain guidelines that are specific enough to resolve disagreements between trading partners. Nor does it contain guidelines or tools for industry practices that were adopted or changed since it was published.

The focus of the JIR was primarily on damaged goods, but today's use of reclamation centers includes unsaleables of all kinds as well as other situations such as product recalls. The cost definitions and guidelines remain valid as far as they go. However, several processes have changed since 1990. For example, manufacturer sales representatives seldom pick up unsaleables, and third-party service providers often do. As a result, the costs associated with the non-JIR uses of reclamation centers and with process changes since 1990 remain undefined.

The Unsaleables Leadership Task Force recommends that individual trading partners continue to use the voluntary guidelines and tools published in the 1990 JIR for efficient product reclamation along with the recommendations contained in this report which address today's key issues.

UNSALEABLES INDUSTRY CHANGES

Recognizing that the 1990 JIR has served the industry well, the fact remains that it was published 15 years ago. During that time general industry practices have changed, some new practices have emerged and some old practices have ceased.

Examples of significant changes in industry practices and conditions since 1990 are as follows:

- Some manufacturers pay from "non-JIR" rates. They are typically called "adjustable rates" or "swell allowances," which are derived from a variety of methodologies and are often applied differently by manufacturers.
- Most companies have developed policies covering unsaleables business practices. Conflict between trading partners can result when a manufacturer's policy differs from a distributor's policy.
- Most reclaim centers are now operated by outside companies, whereas most were operated by retailers or wholesalers in 1990. Facilities have consolidated and now process unsaleables more efficiently.
- Environmental regulations for landfills are more stringent now.
- Deductions are now used more often for claims and payments.
- Service companies process claims for some manufacturers and may be part of the deduction authorization process. Service companies pick up for some manufacturers at reclamation centers, where products are held for shorter time periods.
- Salvage revenue is significant for some retailers and some manufacturers.
- New Bioterrorism Act recordkeeping requirements cover reclamation centers and exclude food banks.

Since operating in the current business environment is critical to the viability of any company, the Unsaleables Leadership Task Force eagerly accepted the charge to "revisit the JIR" and create a new set of industry guidelines for efficient and effective unsaleables cost management.

INDUSTRY PERSPECTIVES

In order to understand the complexity of the issues surrounding unsaleables, it is important to consider the larger picture. The food and OTC drug CPG industry has experienced widespread cost cutting in the past two decades, yet the cost of unsaleables has not declined significantly.

As the Unsaleables Leadership Task Force tackled the issues surrounding unsaleables, it turned its attention to processing facilities known as reclamation centers. The task force points out that unsaleables products have always existed and are expected to be an ongoing condition of the CPG manufacturing and distribution industries for the foreseeable future. At the core of many current friction points on unsaleables, however, is the reclamation center.

The following implications were identified by the Unsaleables Leadership Task Force for what might result at the total industry supply chain level if all **product reclamation centers ceased operations.**

POSITIVE IMPLICATIONS

1. Potential reductions in certain supply chain costs such as transportation.
2. Increased motivation to improve store-level operations to reduce and manage unsaleables.
3. Reduction in amount of saleable product available to unauthorized salvage outlets such as flea markets and other "tertiary" dealers.
4. Elimination of additional processing and auditing fees where services are currently conducted after traditional reclamation processing.

NEGATIVE IMPLICATIONS

1. Increased warehouse and store processing and disposal costs, and potential liability of non-centralized disposal of sensitive materials.
2. Increased amount of damaged and discontinued expired product in stores.
3. Potential image decline for store and brand.
4. Need for new reimbursement and claim processes at store level.
5. Loss of opportunity to salvage unsaleables and recyclables from a centralized location.
6. Inability to selectively control salvage distribution (e.g., to outside of a retailer's market area).
7. Loss of volume donated to food banks.
8. Loss of centralized process for recalls, seasonals, continuities and returns.
9. Loss of reclamation center processing data.

The Unsaleables Leadership Task Force observes that a significant and undeterminable amount of cost transfers would likely occur across the supply chain if all reclamation centers were to close.

In addition to what could happen if all reclamation centers closed, the following implications were identified as the **reclamation center industry consolidates.** Unlike the prior scenario, these observations are based on real-world experiences as distributors move to a regional concept and away from a one-reclamation-center-per-warehouse concept.

POSITIVE IMPLICATIONS

1. Reduced fixed overhead costs from consolidation.
2. Reduced variable costs from synergies.
3. Fewer business entities to deal with.
4. Improved consistency in processing and reporting practices.
5. Shorter salvage pick-up cycles.

NEGATIVE IMPLICATIONS

1. Increased processing time (cycle time).
2. Increased transportation costs from longer distances traveled.
3. Increased risk of infestation.

The Unsaleables Leadership Task Force concludes that:

- **Reclamation centers are currently the most efficient way to remove unsaleable products from the supply chain** and that they are viable tools for unsaleables management.
- **The negative implications to the supply chain if all reclamation centers ceased operations outweigh the positive implications.** Manufacturers and distributors would not be able to readily remove or recall damaged or otherwise compromised products from distribution in the supply chain and would lose centralized data for root cause corrections.
- **The reclamation center industry is in a consolidation phase that will likely result in fewer processing facilities.** Some consolidation is driven by retailers and wholesalers; other factors such as mergers and acquisitions of companies that operate reclamation centers are also currently in play.

The Unsaleables Leadership Task Force recommends that industry leaders consider the current role and implications of reclamation centers during top-to-top dialogues so that manufacturers and distributors can move closer together on their understanding of how to improve efficiencies in the system and take costs out rather than merely shifting costs among trading partners.

ADJUSTABLE RATE POLICIES

During the last few years, some manufacturers have published unsaleables policies that include the adjustable rate method for defining reimbursement to customers for unsaleables. Known as "Adjustable Rate Policies" (ARP), these approaches are generally considered a departure from the traditional "JIR" policy method. Industry dialogue around ARPs has become strained, in part due to the variations in approaches taken without industry-level voluntary guidelines, such as those available for manufacturers developing JIR-based policies.

This section of the white paper is offered as a set of voluntary guidelines for individual manufacturers that are interested in developing an ARP for unsaleables. It is also expected to be useful for trading partners to evaluate existing adjustable rate policies. This section should not be construed as a recommendation by the Unsaleables Leadership Task Force for, or against, the ARP method of reimbursement definition.

The Unsaleables Leadership Task Force recommends that individual manufacturers consider both methods — the JIR and the ARP methods — in conducting their due diligence about most appropriate methods for use in their individual unsaleables policies.

Definition of Adjustable Rate Policy

The following definition is from "Adjustable Rate Policies: An Unsaleables White Paper" published by GMA, FMI and FDI in 2002: "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 manufacturers and/or third-party auditors and typically was expressed as a percentage of the manufacturer's sales to the retailer."

The task force observes that historical data about unsaleables may not be adequate to fully represent future experiences. Forecasting the occurrence of unsaleables is a complex undertaking that should include considerations for a number of factors. The next several pages in this section are devoted to addressing this complexity and offering recommendations for individual companies to consider when developing an adjustable rate.

Swell allowances are similar to ARPs in that they are a percentage discount applied to a manufacturer's invoice, but they are different in several important developmental areas. The following discussion, therefore, is not intended to apply to swell allowances. For more information about ARPs, see "Adjustable Rate Policies" available at gmabrands.com or fmi.org.

Key Attributes

When designed and administered properly, an adjustable rate policy should provide benefits and incentives to all trading partners. Effective, equitable and credible ARPs have four key attributes:

1. The policy should be **based on statistically sound data** that measure the performance of a manufacturer's products and packages **throughout the entire supply chain.** These data are used for two distinct and important purposes:
   - Defining opportunities for performance improvements.
   - Establishing the rates that the manufacturer will use to compensate customers for unsaleables.

   The objective of the ARP data collection process, typically called a "supply chain audit," is to capture the actual incidence of unsaleables and the corresponding drivers that lead to the incidence in order to understand how, where and why unsaleables occur. Ultimately, this leads to an assignment of responsibility for the unsaleables based on factual information about cause.
2. The **measurement process should be ongoing and be the basis for periodic adjustments** to the compensation rates. Continuous measurement is necessary in a functioning ARP program because the actual rate of unsaleables will change over time due to new product introductions, improvement initiatives, new packaging, distribution technology changes, mergers, divestitures and consolidation, to name a few.
3. The policy should **address all causes of and responsibility for unsaleables** in a way that fairly acknowledges the challenges and costs associated with the way in which the company does business with its trade partners.
4. The backbone of an ARP program is **a commitment to continuous improvement.** This includes active investigations of the supply chain to identify physical solutions as well as a pervasive and multifunctional engagement in managing unsaleables within business practices internally and with trading partners.

ARP MEASUREMENT SYSTEM
- Topics to be included in ARP
- Measurement system design
  - Product groups
  - Sample sizes
  - Sampling locations
  - Measurement points
  - Measurement criteria
  - Sampling frequency
- Database design
- Data evaluation criteria
- Compensation rate calculation criteria
- Process owner accountability
- Performance improvement standards and targets

The Unsaleables Leadership Task Force recognizes that some of these voluntary guidelines may be difficult for some companies to follow or even evaluate due to limited internal resources. The supply chain audits, for example, are particularly labor intensive. One option for some manufacturers may be the use of independent third-party service providers to supplement limited internal resources.

What Should Be Included in an ARP

The following table contains general descriptions for the topics that should be referenced in an ARP. It also contains the Unsaleables Leadership Task Force recommendation for which trading partner owns the costs and the processes associated with each topic.

TOPIC	DESCRIPTION	COST OWNER	PROCESS OWNER
Manufacturer-caused unsaleables	The inability to endure the reasonable rigors of the normal supply chain processes through to consumer takeaway.	Manufacturer	Manufacturer
Warehouse-caused unsaleables (wholesale or retailer DC)	Improper or unreasonable handling or insufficient preventive measures at DC level.	Retailer/Wholesaler	Retailer/Wholesaler
Consumer-caused unsaleables	The integrity of the package has been compromised by the consumer in the store.	Shared	Retailer
Store-caused unsaleables	Improper or unreasonable handling or insufficient preventive measures at store level.	Retailer	Retailer
Expired Products	Failure to sell through within the indicated shelf life.	Shared	Shared
Handling fees	Costs associated with handling those products identified as unsaleable within the total supply chain, including reclamation centers	Shared	Retailer/Wholesaler

The decision regarding the components that make up an adjustable rate unsaleables policy for a manufacturer should be one that requires extensive analysis. An organization should evaluate its ability to consistently measure and retain accurate data relevant to the individual components and the methods by which it conducts business with its trading partners in various supply channels.

Additional Topics That Should Be Discussed

Additional topics related to unsaleables need to be discussed between trading partners to determine an exit strategy and extraordinary situation handled outside of an Adjustable Rate Program. These topics deal with residual inventory or excessive damages.

ADDITIONAL TOPICS THAT SHOULD BE DISCUSSED	
Manufacturer discontinued/withdrawn	Products that have been removed from distribution by the manufacturer.
Distributor discontinued	Products that have been removed from distribution by the distributor.
Seasonal products	Products that have a limited selling season or that have significant peaks in their sales cycles.
Promotional products, special packs, shippers	Specific promotional activities or vehicles that create increases in volume of products in the supply chain during the promotional period.
Underperforming new product/ category launches	Products that do not meet the sales expectations and are at risk for becoming out-of-date (expired).
Product transition	Similar to discontinued products except focused on item replacement such as improved formulations, package graphics changes, etc.

Overs, shorts and damage (O, S & D) are delivery exceptions due to count discrepancies or damage upon delivery to the customer and are generally covered elsewhere.

The decision regarding the components that make up an adjustable rate unsaleables policy for a manufacturer is one that requires extensive analysis. An organization should evaluate its ability to consistently measure and retain accurate data relevant to the individual components and the methods by which it conducts business with its trading partners.

Setting the Rate

The Unsaleables Leadership Task Force recommends a continuous process for determining the reimbursement rate in a manufacturer's ARP rather than a one-time calculation that remains in place for years. The baseline steps described below would typically be conducted in the development of an ARP; the update steps would be repeated year after year. As described earlier, the rationale for this recommendation is the dynamic nature of the CPG industry and its supply chain. Therefore, the following dynamic process should be taken into account by a manufacturer interested in developing an adjustable rate policy for unsaleables.

Baseline Steps

1. **Logically group products into business units or categories.** This grouping process should take into account at least the following physical attributes:
   - Package type and size (cube) — both primary consumer unit and secondary shipper
   - Category variations
   - Shipping platform types
   - Distribution modes
   - Total shelf life in days
   - Minimum days of shelf life remaining at time of shipment

   This becomes the master product data file for use in calculating and updating the adjustable rate. Log the following dynamic data into the database:
   - Volume data by business units/categories by channel
   - Inventory turns data by business units/categories by channel

   The database may be held in a separate system at some companies where an integrated approach is not feasible.

KEY ISSUE
Salespeople need to know how the audit data are rolled up to the adjustable rate and share that information with distributor customers.

2. **Map the physical supply chain flow** including all processes and touch points and potential measurement points for the audit. The map should include production facilities through reclamation centers and all points in between. This mapping process should include the identification of each type of order selection/retail distribution methodology, which may be channel specific. Also map the data transfer processes related to the physical flow of goods. Finally, identify all processes within the supply chain map where product and package performance is potentially impacted by the processes.

RECOMMENDED AUDIT METHODOLOGY

- Sample all touch points in supply chain.
- Sample in each calendar month.
- Sample all customer channels.
- Sample all geographic regions.
- Sample all manufacturer shipping points.

3. **Develop a statistically valid supply chain audit sample and schedule** that takes into account the following key variables:
   - *Calendar cycles* – Supply chain audits should be conducted in all months of the year to capture the impact on unsaleables from variables such as temperature, sales velocity extremes and consumer demand fluctuations, to name a few.
   - *Customer channels* – Supply chain audits should be conducted in all channels in which the manufacturer does business in direct proportion to channel share of the manufacturer's business.
   - *Regionality* – Supply chain audits should be conducted in all geographic regions in which the manufacturer does business in direct proportion to the region share of the manufacturer's business.

   It is recommended that manufacturer shipping points be included in the audit sample.
4. **Conduct the initial audit** using qualified internal or external resources and collect the data in an archivable and accessible format.
5. **Determine the adjustable rate(s)** following the appropriate suggestions described below (see Types of Rate Applications).

Update Steps

1. **Review baseline steps 1-3** and make changes where necessary due to all dynamics of the business, including, but not limited to:
   - New item introductions
   - Product discontinuations
   - Brand and company mergers, acquisitions and divestitures
   - Customer mergers and acquisitions
   - Market share changes
2. **Conduct the update audit** using qualified internal or external resources, and collect the data in an archivable and accessible format.
3. **Calculate the adjustable rate(s)** following the appropriate suggestions described below (see Types of Rate Applications).

Types of Rate Applications

These methods for allocating the unsaleables reimbursement rate are in general use among manufacturers with adjustable rate policies:

- **A national average** applied to all customers. This may be calculated across all of the manufacturer's products or separate averages may be calculated for each major group of products.
- **A channel average** calculated for each of the manufacturer's customer channels. Again, one average per channel may be calculated for all products or separate averages may be calculated for product groups.
- **A geographic average** calculated for each major marketing area in which the manufacturer does business. This could be one rate for all of the manufacturer's products or channel-specific or product group-specific averages could be calculated.

The Unsaleables Leadership Task Force recognizes that each manufacturer must determine which type of rate or combination of rates is appropriate, fair and equitable. The task force recommends that individual manufacturers conduct a robust supply chain audit and consider the results of that audit across the three major variables (product group, customer channel and geographic region) when choosing the appropriate type or types of rate averaging.

Open Dialogue, Access and Review

Regardless of the type of rate calculation used by a manufacturer, the Unsaleables Leadership Task Force strongly recommends open dialogue about non-confidential details regarding the development of the adjustable rate. This means that manufacturer sales representatives or agencies charged with communicating new or revised unsaleables policies to distributors should be equipped with adequate documentation describing both the audit methodology and the average rate calculation methodology.

The task force encourages retailers and wholesalers to provide open access in support of supply chain audits that manufacturers may request for their adjustable rate programs. The task force believes that it is in the best interest of the industry to allow non-disruptive access to reclamation centers, stores and warehouses for the purpose of investigating causes of unsaleables.

Since multiple department and accounting systems are often involved in managing unsaleables, it is important to include adequate lead-time for communications about policy changes. In general, two sets of topics would be covered — those relating to operations and those relating to merchandising.

The task force recommends that all unsaleable products be processed though reclamation centers without regard for the type of manufacturer reimbursement method. The task force cautions that if ARP-covered products are not processed in reclamation centers, valuable data will not be captured, store conditions may decline, and consumer safety and brand equity may be at risk.

Policy Transition

Some manufacturers may decide to change their unsaleables reimbursement method from a "JIR"-based approach to an ARP. Since this results in a shift from post-payment to pre-payment for unsaleables, the inventory and unsaleables that reside in the retailer and wholesaler supply chains at the time of the policy change also need to be addressed. Two approaches are currently used to address this inventory:

- **An overlapping transition period** determined using the weeks of supply that the distributor owns to define the length of the period. The manufacturer would reimburse the distributor using both the pre-payment (JIR-based) and the post-payment (ARP-based) methods during the transition period. At the end of the transition period, the distributor would no longer be eligible for the post-payment.
- **A one-time pre-payment** made by the manufacturer for the inventory in the distributor's supply chain that the manufacturer sold to the distributor and that has not been invoiced to the manufacturer by the reclamation center. The appropriate adjustable rate determined by the manufacturer can be applied to the value of the distributor's inventory, as defined by an agreed-upon valuation methodology.

Using either approach, trading partners should also consider any reclamation center claims that are being processed and disputes that are being resolved. Normal accounting cycles of payment and reconciliation should also be considered. Individual manufacturers independently or in conjunction with individual trading partners may determine that some other method is more appropriate to use to account for the transition from a "JIR" policy to an ARP.

In situations where a manufacturer's policy changes from ARP- to JIR-based methods, a similar transition would also occur. Each approach described above could be used to account for the inventory that is in the distributor's possession. However, the payment process would be in reverse.

- No reimbursements would occur during a transition period.
- The distributor would re-pay the appropriate adjustable rate payment to the manufacturer for a one-time settlement.

In some instances, distributors may discover data that indicates additional payments are due under the manufacturer's policy. Generally known as "post-audits," these claims for reimbursement for unsaleables should be communicated to manufacturers within a reasonable time period. The Unsaleables Leadership Task Force recommends that trading partners "close the books" on post audits of unsaleables claims that are two or more years past the date of the discrepancy.

TODAY'S KEY ISSUES AND RECOMMENDATIONS FROM THE TASK FORCE

1. **The topic of unsaleables is inherently rife with conflicting beliefs and agendas, inhibiting major progress on fundamental system improvement.**

   Some of the conflicts that stymie trading partner progress in unsaleables management are as follows:

   - Different opinions about the causes of unsaleables create discontinuity in industry perceptions.
   - Multiple processing by service providers may result in count and claim discrepancies.
   - The definition of physical control or ownership of unsaleables is not generally agreed upon between manufacturers and distributors. This and other policy and practice disagreements harm trading partner relationships and increase adversity.
   - The salvaging of products covered under swell allowances and adjustable rates can cause those products to bypass normal reclamation center processing. This results in no data being captured for these products and reduced control over their eventual disposition.
   - Product diverting complicates unsaleables management for manufacturers and distributors.

   The Unsaleables Leadership Task Force observes that these and other conflicts are causing harm to trading partner relationships.

The Unsaleables Leadership Task Force recommends that trading partners collaborate on efforts to reduce the quantity of unsaleables and repeatedly reinforce that collaborative strategy as a tangible mission in order to mitigate some of the conflict around unsaleables.

2. **The industry currently exhibits a fundamental disagreement on the issue of cost recovery for unsaleables.**

   One of the results of this disagreement for some trading partners is the compromising of terms of sale agreements. In general, the Unsaleables Leadership Task Force concurs with the intent of the 1990 JIR cost components approach to defining a template for cost recovery discussions among trading partners.

   - Product cost – Current manufacturer list cost (bracket defined by manufacturer) is the most readily available data for use by the information systems that generate claims from reclamation center scanners. In the future, if acquisition cost data become synchronized throughout the industry, the Unsaleables Leadership Task Force recommends adopting it as a more accurate record of product value to the distributor for purposes of investment cost recovery.
   - "JIR handling costs" – Unsaleable product processing to and through a reclamation center today remains "piece-work" processing, much the same as it was in 1990. In other words, the cost to process a can of coffee is essentially the same as the cost to process a can of corn, on a cents-per-piece basis. Handling cost reimbursement and recovery decisions should continue to use the cents-per-piece methodology.
   - Low-cost products adjustment – The economics for low-cost products are different than for the majority of products in the unsaleables supply chain. Therefore, trading partners should consider a lower handling cost reimbursement and recovery for those products.

Some distributors and/or manufacturers may prefer to use a percentage basis to recover/reimburse an equitable handling cost for unsaleables. For those companies, the Unsaleables Leadership Task Force recommends a methodology to determine handling cost percentage by beginning with the average list cost and the average cents-per-piece handling cost.

The Unsaleables Leadership Task Force recommends that trading partners adopt a mission of cost reduction in addition to cost recovery in discussions that involve reimbursement for unsaleables costs.

3. The cause of unsaleable product condition is often difficult to determine after processing through a reclamation center.

While the intent of the 1990 JIR — to define responsibility by product condition — was admirable, in practice today, few companies have been able to invest the resources needed to determine where in the supply chain a product became "dented," for example. Those companies that do invest in "hidden damage audits" incur significant expenses. These studies often lead to packaging or manufacturing process improvements, making them important investments. However, many companies may not be able to afford these investments.

Industry data about "razor cuts" indicate that this product condition is minimal. Unsaleables Leadership Task Force distributors concur, with some paying special attention to razor cuts as a means of supervising store operations.

This unsaleable condition is worthy of particular note because it was considered a significant challenge for the industry in 1990. As such, razor cuts were identified as the only type of damage to be the sole responsibility of distributors. The low incidence of razor cuts today is credited to attention paid by all segments of the supply to fixing this problem.

Another notable improvement, generally credited to manufacturers, is the reduction in damaged pet food bagged products. According to one manufacturer, attention was drawn to this problem during the early years of applying the voluntary guidelines from the 1990 JIR.

The Unsaleables Leadership Task Force recommends that trading partners continue to use product condition data, where possible, to identify opportunities to further investigate where and how the cause of product unsaleablity occurs in the supply chain. The collaborative investigation process is the generally recognized best practice for root cause control and unsaleable quantity reduction.

4. Saleable product exists in the reclamation center supply chain.

Most of the language in the 1990 JIR referenced damaged goods, which is a subset of the broader term of unsaleables. The 1990 JIR guideline to keep undamaged products from being sent to reclamation centers is still considered an important recommendation today because otherwise saleable product can easily become unsaleable in the reclamation center supply chain.

However, the industry has accepted the use of reclamation centers as an efficient means for other processing applications, such as product recalls and tobacco products. In some circumstances, trading partners now use reclamation centers to consolidate saleable product returns from stores as part of mutually agreed-upon programs.

Nevertheless, industry data from third-party audits suggest that a significant share of unsaleables volume is saleable. (See Unsaleable Benchmark Survey 2000-2003, 2005). Some of this saleable product has been determined by individual companies to be product that was discontinued by either a manufacturer or a distributor. See the guidelines for these situations: *Improving Efficiencies in Product Discontinuation: An Industry White Paper,* 2001, FMI, GMA, FDI.

In some cases, saleable product may be remnants of partially damaged cartons. This is a special challenge for wholesalers that cannot ship damaged cases to their retail customer.

Finally, non-traditional grocery items such as electronics, pharmaceuticals and hardware may also become unsaleable. Guidelines for other categories may be available from their associations' publications. (See the bibliography for additional information.)

The Unsaleables Leadership Task Force recommends the following guidelines for product distribution to reclamation centers:

- *Reclamation centers should be used as efficient consolidation and control for non-damaged product where mutually agreed upon by trading partners.*
- *Except for recalls, products that should not be sent to reclamation centers include DSD product and other products not distributed through the distributors' warehouse.*
- *For temperature-controlled products, only clean, empty packages should be sent to reclamation centers; contents should be destroyed at the store. Retailers with systems capability should scan products in stores.*
- *Hazardous materials from unsaleable products may be safely processed through reclamation centers as long as special handling and labeling controls are practiced.*

Except as noted above, product in saleable condition should remain in the store for sale to the consumer.

RECOMMENDED FIELDS FOR UNSALEABLES CLAIMS (EDI OR PAPER)

Header Fields

Invoice number
Manufacturer name
Vendor ID number
Manufacturer address
Period for claim
Date of invoice/claim
Date of payment due
Reclamation center name
Reclamation center address
Distributor name
Distributor address
Remit payment to name
Remit payment to address
Total dollars claimed
Method of payment

Detail Fields

Item UPC
Item description
Reason code
Disposition
Quantity
Item price
Store DPC handling fee
Warehouse handling fee
Reclaim center handling fee
Total item claim

5. Invoice deductions are increasingly used for unsaleable cost recovery and reimbursement, sometimes without adequate documentation.

Often cited as a major friction point between trading partners, deductions for unsaleables place administrative cost burdens on manufacturers, distributors and sales agents. This becomes especially fractious when the arrival of specific information (i.e., "back-up data") about the deduction does not coincide with the deduction transaction. Trading partners routinely engage in phone calls, faxes and e-mails attempting to locate the missing information.

The Unsaleables Leadership Task Force believes that undocumented or otherwise unauthorized deduction for unsaleables add an unnecessary cost to the supply chain. In addition, the general industry practices surrounding reclamation claims communication and reimbursements are often outdated and require significant manual intervention.

While some claims are transmitted through electronic file transfers or Web site downloads, those files are generally text files at this time. As a result, the company receiving the claim file must key enter data into its own system, just like it would do for a paper-based claim. This adds time, cost and the potential for error. New document scanning technology can improve this process, but it is still manually supervised and audited.

Prior to deduction or claim communication, another data communication may occur between manufacturers and distributors. Often called the "item price file," this data file contains information about the manufacturer's products intended for use in the system that generates the unsaleables claim.

The item price file communication is also generally implemented through manual procedures. In both communication events — the invoice or deduction documentation and the item price file — no industry standard communication protocols currently exist to enable more efficient electronic file transfers. However, several industry initiatives are currently progressing for data pool and synchronization communication standards and protocols.

The Unsaleables Leadership Task Force recommends that standards development organizations, e-commerce data pools, and providers of related services and solutions consider expanding their current data synchronization and registration initiatives to include applicability for unsaleables data communications and synchronization.

APPENDICES

Overview of the 1990 JIR

Existing guidelines for unsaleables management were published in 1990 in a report sponsored by six associations titled “Product Reclamation Centers: A Joint Industry Report” (JIR). Since then, a number of industry conditions have changed, while the fundamental reason for the industry’s interest — the existence of damaged, expired and otherwise unsaleables products in the supply chain — has remained in place.

The JIR contained two separate and distinct sections:

- A set of **recommendations for fair and equitable business practices** for manufacturers, sales agents and distributors in dealing with the issues surrounding unsaleables. The guiding philosophy for these recommendations was defined as the Generally Accepted Presumption for Unsaleables Responsibility (GAPUR).
- A **cost study of the handling and operating costs** of a typical product reclamation center. Time and motion studies were conducted in six facilities, and operation cost factors were collected at 24 facilities. Averages were developed and published for all processing variations in existence at the time.

The JIR emerged as a consensus from the 1990 Joint Industry Reclaim Center Committee, which included a broad cross-section of industry representatives from the six sponsoring associations. Thirty-two individuals actively participated, half working on each section of the report. Seventeen held the title of vice president or higher in their respective organizations.

Selected Passages from the JIR

Packaging problems

"This reclamation process should also provide the information necessary to identify and correct manufacturers' packaging problems as well as distributors' and manufacturers' handling problems."

Profits

"This system should not create incentives to remove saleable products from the store, nor should it encourage inappropriate handling techniques leading to product damage. Therefore, the intent of the reclamation process is not to enhance profitability for either the manufacturer or distributor."

Shared Responsibility

"The manufacturer's responsibility is to devise a system of compensation for such cost components which recognize the need for universally credible, equitable, non-discriminating treatment of all customers regardless of size, store format, or geographic location."

"For the distributor, this means:

- billing only for damage which is the agreed responsibility of the manufacturer.
- operating the most efficient, low cost reclaim center(s) possible.
- seeking only to recover reasonable offsets for operating expenses, and not to generate a profit."

"A cooperative effort may be needed to determine the true cause of the damage and to negotiate the financial responsibility."

Disposition

"The party incurring financial responsibility for products processed through the reclamation center should determine the method of disposal and bear any incurred cost."

Reimbursement

"Responsibility for the cost components of operating a product reclamation center must be determined by individual manufacturers discussion with their trading partners."

Alternatives

"Individual trading partners may determine that the removal of unsaleables through reclaim centers may not be the most efficient and less costly alternative in every instance."

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Glossary

Adjustable Rate Policy (ARP) – A monetary cap on the amount a manufacturer pays distributors for unsaleables. These caps can be adjusted, up or down, based on the manufacturer's own audit process and findings.

America's Second Harvest – The national network of local food banks that administers operating standards and guidelines while assisting in the distribution of products to the needy.

Cause of Damage – How a product came to be damaged. Often confused with the type of damage (product condition). For example, "razor-cut" describes the visible damage — not why or how it happened. Some causes of razor cuts have been found to be poor case design and improper opening techniques.

Damaged Goods – Unsaleable products that are physically damaged, e.g., broken, cut, crushed, dented, etc.

Disposition – The path taken by unsaleable products, e.g., donate, destroy, salvage, hold for pick-up or return to supplier, to name a few.

Food Banks – Nonprofit organizations that accept unsaleables from a reclamation center and process them along with other donated products for distribution to local feeding agencies, such as soup kitchens and food pantries.

JIR Policy – An unsaleables policy based on the 1990 Joint Industry Report. Generally refers to the reimbursement method in the policy. The JIR method includes a cents-per-package handling fee.

Joint Industry Report – The 1990 publication by GMA, FMI, NACDS, NFBA, NAWGA and NGA that defined voluntary guidelines for unsaleables processing and related cost recovery. The full title of the publication is "Product Reclamation Centers — A Joint Industry Report."

Out-of-Code (Date) – Product that has "expired" based on the date code printed on the package or case. "Open-coded" means readable by consumers; "closed-coded" means unreadable by consumers. Manufacturers determine the code date based on quality and production parameters.

Policy – A written document that states a company's position and practices with trading partners. An unsaleable policy guides discussions and practices with trading partners on the handling and disposition of unsaleables and on the reimbursement practices.

Pre-Damage Direct Product Cost – These handling and storage costs occur before damage is identified as an item moves through retail distribution. They include costs incurred at the warehouse, during transportation to the store and at the store itself. Store costs for retail shelf space, checkout and bagging are excluded.

Post-Damage Handling Costs – These costs typically occur after damage to the item has been identified in the store and before it arrives at the reclamation center if it is sent there.

Reclamation Center – A collection point for damaged goods and other unsaleables, often affiliated with a warehouse distribution center. In these facilities, physical processing occurs, invoices are created, data are captured and disposition is managed.

Reimbursement – Generally refers to the manufacturer's payment to a distributor or sales agent for an invoice for unsaleables. Sales agents may also reimburse stores for unsaleables.

Returned Goods – Generally saleable products that are removed from the primary distribution channel and returned to the manufacturer. Examples include seasonal products, such as insecticides or garden seeds; cosmetics; and seasonal packs with guaranteed sales contracts. Prescription drugs and other controlled distribution products can be returned to the manufacturer for proper disposition.

Swell Allowance – A fixed percentage applied to all products invoiced by the manufacturer and delivered to the distributor's warehouse.

Third Party (Service Provider) – A company that provides unsaleable management services for one of the two trading partners. For example, a manufacturer could use a third party to collect unsaleable product or data; a distributor could use another third party to manage a reclamation center.

Type of Damage (Product Condition) – Condition of an unsaleable product, such as crushed, dented, soiled, out-of-date. Standard industry definitions are published in the 1990 Joint Industry Report: Product Reclamation Centers. Third-party auditors have more extensive categorizations, frequently called "casual factors."

Unsaleables – Product removed from the primary channel of distribution, regardless of the reason for removal. This includes product discontinuations, damaged, seasonal or out-of-code products.

Unsaleables Rate – The dollar amount of unsaleables as a percentage of gross sales incurred for or by the same entity during the same period. Rates can be determined for a total company, division, brand, SKU, customer, store, etc.

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INSIDE BACK COVER

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