eBook

Hidden Transportation and Logistics Costs of Supplier Non-Compliance

TAKE SUPPLY CHAIN

Content

Supplier Non-Compliance: A Form of Disruption You Can Proactively Manage

Retailers and manufacturers are increasing their supply chain complexity, while at the same time focusing on reducing procurement, transportation, and logistics costs.[1] According to a recent supply chain survey conducted by IDC, 58% of consumer products manufacturers and 65% of high-tech companies outsourced some portion of their products, and this percentage is expected to increase as companies expand into new countries. Other recent studies cite regulatory compliance to be the top global supply chain concern, and navigating country regulations as a top barrier to global expansion.[2]

To help with effective distribution in an expanding number of regional markets, retailers as well as manufacturers increasingly rely on third-party logistics (3PL) providers to handle international transport of their products.[3] This strategy enables companies to both reduce distribution costs and mitigate risk of damage or spoilage, and thereby contribute to their primary business objectives.

However, the rise of global sourcing as a means to minimize costs has had the unintended consequence of increasing risk. Dependence on an increasing number of suppliers makes it difficult to monitor their performance without automated metrics. In addition, unforeseen environmental, political, and economic crises can stop a supply chain in its tracks. In fact, according to a *2013 Supply Chain Resilience Survey,*[4] 75% of organizations experienced at least one supply chain disruption incident in the past year.

While organizations can create plans for responding quickly to unpredictable, uncontrollable disruptions, they can do even more to greatly reduce the likelihood of disruptions caused by supplier non-compliance. It is notable that 42% of the disruptions reported in the *Resilience Survey* originated below the tier one supplier; 37% of these were due to "outsourcer service provision failure."

This eBook provides a list of key areas to monitor for supplier compliance, and the hidden financial impacts of non-compliance on your transportation and logistics costs. It also suggests solutions you can implement to increase supplier compliance and your supply chain's resiliency, thereby decreasing a host of costs associated with disruptions.

Areas of Compliance and Financial Impacts

The most common areas where companies tend to require compliance are outlined below, along with the associated hidden transportation, logistics, and other costs.

Regulatory
Example: FDA regulations for the pharmaceutical and food & beverage industries

Financial Impact: Non-compliance costs can include relabeling, re-barcoding, FDA fines, implementing new traceability systems for compliance, and the tremendous shipping and lost sales costs due to product recalls. Last year's horsemeat scandal in Europe provided a stark snapshot of what can go wrong when food suppliers fail to comply with regulations.

Quality
Example: ISO 9001:2000 standard

Financial Impact: Companies may suffer the high costs of product recalls and/or returns:

- freight costs of transporting defective products back to the manufacturing site
- rework/repair/scrap costs for lost product, remanufacture product and labor costs, and transport costs both to final destination and for the new or repaired product to be shipped back to the customer
- other costs such as implementing a supplier quality certification requirement, or obtaining entirely new suppliers that meet quality standards and negotiating new contracts

Financial
Example: Sarbanes-Oxley (SOX) regulation

Financial Impact: Enacted in 2002 in the wake of the Enron debacle, the SOX regulation is intended to prevent financial fraud. Although there is the obvious financial impact of fines, penalties, or audits for non-compliance with financial regulations, suppliers in fraudulent regions who are not monitored closely for compliance may be passing along excess costs to you, including the cost of bribes to political, regulatory, and transportation/shipping agencies.

This may sound like a far-fetched possibility. However, if you have suppliers in multiple regions around the globe, it is likely unless you have complete supplier visibility and transparency. In Transparency International's *Corruption Perception Index 2013*, which covered 177 countries across the globe, more than two-thirds scored less than 50 out of 100 (with 100 being least corrupt).[5] Afghanistan, North Korea, and Somalia ranked the most corrupt on this index, while Denmark, New Zealand, and the UK ranked least corrupt. The report expressed alarm that only a few countries scored well, and no country has a perfect score.

Shipping Process
Example: Business process rules such as acceptable shipping windows, over/under tolerances, split delivery policies, or approved carriers and transportation methods.

Financial Impact: Late or delayed shipments from the supplier can often result in your company routinely bearing the costs required to expedite shipments to the customer in order to make on-time deliveries to retain customer satisfaction and brand reputation. Meeting these deadlines often includes additional labor costs for overtime.

Areas of Compliance and Financial Impacts

Environmental
Example: European Union's Restriction of Hazardous Substances (EU RoHS) directive; REACH

Financial Impact: Loss of potential revenue due to preemptive removal of product from an affected market due to new regional regulations. In 2006, for example, both Apple and Palm (Treo) had to remove products from European markets, resulting in lost revenue and market share from the downtime required to refashion the products for compliance. They also incurred hidden costs associated with maintaining multiple versions of the same product for different markets.[6]

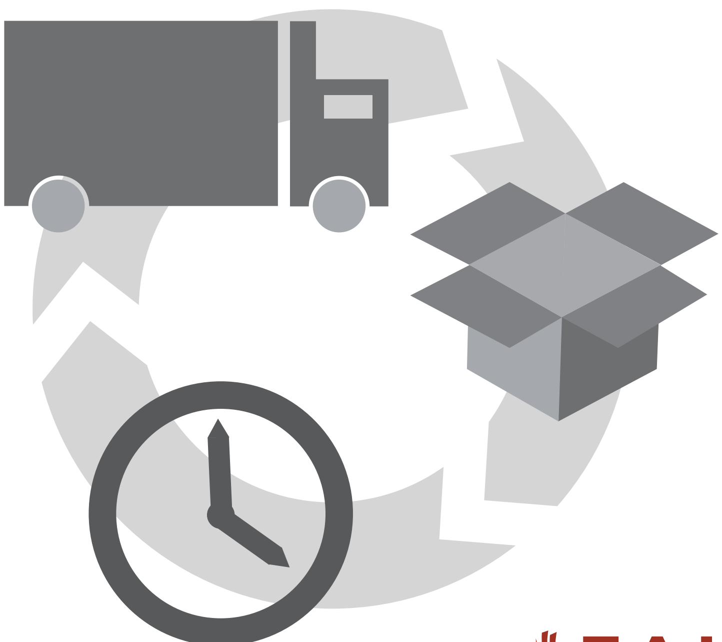
Labeling and Traceability
Example: Companies require suppliers to use package and shipment labels with specific barcode and layout formats, or use serial or lot control for traceability.

Financial Impact: Lot control and traceability helps manufacturers in the case of product defects or contamination. If a product needs to be recalled – for example, the Trader Joe's peanut butter recall in late 2012 due to salmonella contamination[7] – lot control allows the manufacturer to isolate the date(s) and manufacturing plant location(s) of the contaminated substance to recall only the products affected. Using this example, without lot control compliance, the manufacturer would be required to recall every product from every store. This would represent an exponential increase in all costs associated with recalls – including the logistics and transportation costs to ship the product back to the manufacturer, and re-ship new, uncontaminated products to the customer.

Serialization/e-Pedigree
Example: California 2015

Financial Impact: Similar to lot and serial traceability, e-Pedigree and serialization requirements help companies expedite and significantly reduce quantities and shipping costs associated with product recalls. California 2015 is specific to the pharmaceutical industry, though serialization compliance can be mandated by companies in nearly every manufacturing sector.

Transportation Costs and the Empowered Consumer
Although the U.S. has one of the lowest logistics costs of any country, accounting for 8.5% of the Gross Domestic Product,[8] many companies face the significant challenge of record-high customer expectations for rapid transport and perfect quality, brought about largely by the recent rise in ecommerce as companies offer increasingly fast and cheap (often free) shipping to increase market share.



Hidden Costs Associated with Recalls & Customer Returns

Perhaps the biggest driver that will ultimately cost organizations the most is the public (customer) outcry that occurs with each major brand recall or scandal. In an age of social media, where negative public opinion spreads "virally" over the internet in a matter of hours, companies must take seriously the job of managing their suppliers to ensure that standards are being met.

Nowhere is this more challenging than in factories in emerging markets, or any vendor that is not a tier one supplier. The 2013 factory collapse in Bangladesh, for example, led to new government regulations that affect all companies with vendors in that locale. The number of companies affected by new regulations in a region is significant: a recent study conducted by the Center for Strategic Supply Research found that 80% of respondents outsource some processes with the goal of reducing operating costs and focusing on core competencies.[9]

In 2014, more than one-third of U.S. businesses will continue the trend of "reshoring" in an effort to move some critical manufacturing operations back to the States.[10] The goals of reshoring are to:

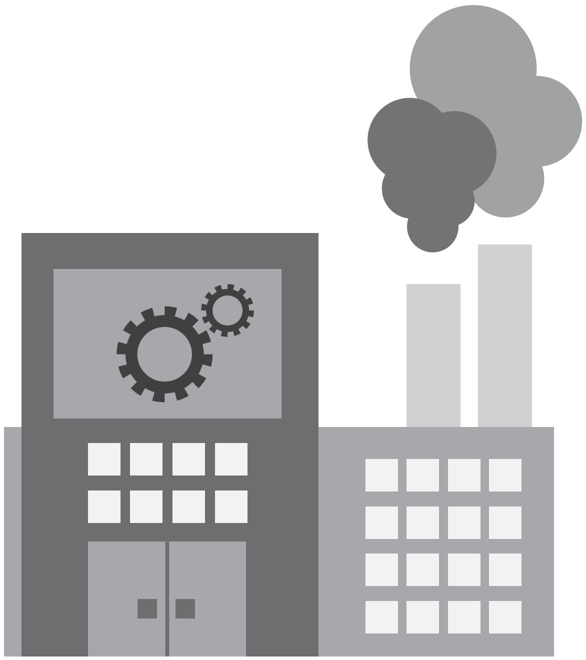
- better ensure that quality and other regulatory standards are met

- avoid costly damage to a company brand from scandals, recalls, or shipment delays

This movement reflects IDC's recent report that improving product quality/ safety has become a top priority, along with reducing overall costs and improving customer service.[11]

Some companies are reshoring despite the increase this will cause in transportation costs due to fewer localized factories. They are betting that the known cost increases will still be far more economical than the unknown potential costs of brand damage, recalls, or returns due to quality issues from suppliers across the globe. These increased costs

Hidden Costs Associated with Recalls & Customer Returns



include transportation over greater mileage, as well as the price of oil, which is generally guaranteed to increase over time. Recently, experts have calculated that for every $10 increase in the cost of a barrel of oil, the transportation cost for one mile increases four cents.[12]

However, it is important to remember that using a US supplier does not guarantee automatic quality standards or compliance. For example, the 2010 automotive industry recalls that severely damaged public perception of both Toyota and Chrysler were found to be the result of lack of adequate quality control from a critical supplier based out of Indiana. Ultimately, in the eyes of the empowered consumer, the government, and regulatory agencies, responsibility for quality and safety resides in the host organization. Since your company will be held financially responsible for supplier non-compliance, managing their performance is paramount in order to prioritize product quality.

When a manufacturer must preemptively remove a product from the market due to non-compliance with a new regulation, the company loses both potential revenue and possibly even market share. In addition to the more obvious lost revenue from lack of sales, companies will incur the additional costs of transporting and tracking all of the recalled products from every end location, back to the place of origin – the manufacturer warehouse. The reverse logistics costs involved in this process can even total more than the original costs to ship products to their end location.

Individual customer returns, though on a smaller scale, incur shipping costs in both directions. If suppliers do not meet your quality standards, or the quality levels that customers expect from your brand, returns are costly in terms of both brand reputation and dollars. It is standard to provide free shipping for returns due to defective products, as well as to provide customers with new parts or products free of charge. Moreover, in today's climate where customer service is a primary directive, you can expect to pay premium rates for expedited delivery.

Once any product has been returned, companies must then decide whether they can rework (depending on the industry and type of material, defect, or recall), or if it must be scrapped. Either way, refurbished items sold at a discount (usually by a third party) and scrap material incur transportation costs to carry the items to their new destinations.

In 2008, the Center for Devices and Radiological Health (CDRH) determined that 5-10% of all recalls were due to "nonconforming product/material in purchased components."[13] To mitigate the costs associated with substandard supplier performance, companies can adopt visibility, collaboration, and traceability systems and processes to ensure that suppliers meet both regulatory and consumer standards.

Conclusion

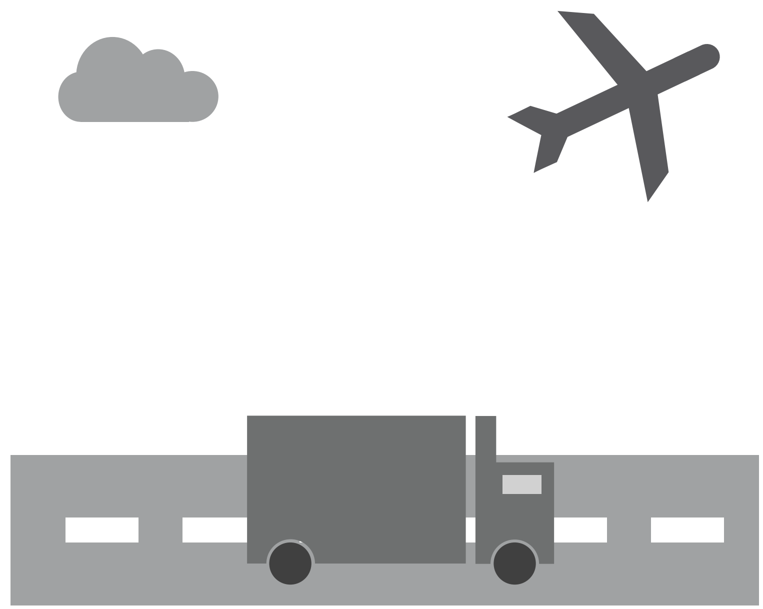
Supplier compliance is increasingly complex to manage as supply chains are spread farther globally and use disparate systems for Procure-to-Pay (P2P) functions. At the same time, new financial, environmental, and traceability regulations add to your own business process and quality requirements. If supplier performance is not carefully monitored, measured, and managed, companies can suffer increased recalls and returns, incurring significant – though often hidden – transportation and logistics costs that negatively affect the bottom line.

Despite these realities, only 10% of companies in a recent survey stated that all of their key suppliers had business continuity measures in place to address their own needs. Fifty percent of respondents stated that half or less of their key suppliers had such processes; and 20% stated that ***they do not even ask their suppliers*** what measures they have in place.[14] Approximately one-third of respondents stated that they require suppliers to show proof of certification to industry standards such as ISO.

In addition to asking suppliers these questions about implementing solid practices for their own purposes, organizations can further protect themselves by implementing best practice solutions for ensuring supplier compliance to their standards in order to prevent non-compliance disruptions and increased transportation and logistics costs. These solutions include:

- automating processes such as Procure-to-Pay, data input, and approvals
- using workflows (business process management tools) and supplier scorecarding to ensure compliance
- implementing complete track-and-trace systems to accurately track product data and location throughout the product lifecycle

Successful supply chain strategy is dependent upon implementing automated systems for tracking supplier credentials, certifications, and financial and operational performance. Putting systems and business processes in place to ensure that all of your suppliers comply with applicable regulations and standards will help you achieve your business goal of decreasing transportation and logistics costs, even as volatility and disruptions continue as the "new norm."



Endnotes

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