

Complexity in the US Apparel and General Merchandise Supply Chain

Billions of dollars of waste and inefficiency exist in the retail supply chain, which impact the bottom lines of both parties. One of the organizations which studied the issue of deductions extensively is the Credit Research Foundation (CRF). In 2009 CRF commissioned a study of 700 companies, which found that for companies selling into retailers, deductions represent 2% of outstanding receivables. For certain merchandise categories the Days Sales Outstanding (DSOs) are even higher. For example, the consumer electronics segment struggles with deductions representing 4% of Accounts Receivable (AR). On the other extreme the toys, games and sporting goods segment only has 1/2 to 1% of AR tied up in deductions.

The Three Types of Deductions

Attain Consulting group, one of the industry's leading authorities on retail deductions, classifies them into three categories—intentional, preventable and unauthorized—which correlate with the manufacturer's view of the problem.

Intentional deductions are expected and anticipated by manufacturers. In fact, these deductions are proactively offered to retailers with the goal of increasing the revenues of the manufacturer. Examples include discounts, rebates, advertising and mark-down allowances, which provide the retailer with an extra incentive to promote their products. Brand owners might use these incentives to try to catalyze sales of a new product line. Alternatively, they might offer trade promotions to encourage the retailer to provide favorable placement of their products in high-traffic or high-visibility areas of the store. The use of these techniques has become so widespread that most manufacturers consider these incentives to be a cost of doing business. Intentional deductions represent 6% of annual sales on average.

Unauthorized deductions are not anticipated by manufacturers, but also have become a cost of doing business for many. Shortages, returns and price discrepancies are the

most common examples, which in aggregate represent 2% of sales. For example, shortages might arise from a lack of finished product inventory to ship to a customer. But with more accurate forecasting and demand-driven supply chain practices, manufacturers can optimize inventory to meet customer needs. Another root cause of shortages is warehouse errors from the picking and packing process. Again, suppliers can reduce these errors through automation technology and quality assurance. However, less controllable by the supplier are incidents of shrinkage in which retailer or distributor employees may deliberately remove product from a shipment.

Preventable deductions are the category that manufacturers have the most control over. Preventable deductions are much smaller percentage of revenue than the intentional category, but still a meaningful 2% of overall sales. These deductions are the result of a supplier failing to properly comply with a retailer's rules for order fulfillment, carrier routing, container labeling, shipment documentation or electronic commerce. For example, a retailer might request that all in-bound shipments be cased and palletized, labeled with a serialized barcode and preceded by an advanced shipment notice to facilitate cross-docking of merchandise through their distribution center. Failure to follow any of these procedures would result in a deduction against the supplier's invoice during the accounts payable cycle. Suppliers have a much greater degree of control over preventable deductions than unauthorized ones.

Examples of preventable deductions include:

- Late or early shipments
- No tickets on floor ready merchandise
- No advanced shipment notice (ASN) or late ASN
- No UPC barcode or unscannable barcodes
- Wrong carrier per routing guide
- Over-shipment or under-shipment
- Shipped to the wrong location
- Unauthorized substitutions

- No retail price or incorrect price
- No hangers
- No packing lists

The Costs of Deductions

There are significant financial implications of deductions for retail suppliers. Extensive deductions can impact profit margins, product availability, working capital and even long-term customer relationships.

- **Profit Margins**—It is not unusual for a supplier to have several million dollars worth of preventable deductions per year. Some retailers use a tiered format in which charges increase as more violations occur. For example, the first 10 infractions are charged at \$500, but the next 10 are \$1000. While these individual penalties might seem insignificant, the compounded affect of the deductions across the retail supply chain represents billions of dollars annually. Preventable deductions, if reduced, offer the opportunity for manufacturers to regain significant bottom line benefits. Suppose a \$100M brand owner has 2% in deductions from its retail customers representing a total loss of \$2M per year. If the manufacturer can reduce “preventable deductions” by 50%, the organization can realize an additional \$1M in profits. \$1M may not seem significant for a multi-billion dollar brand owner, but consider that it could represent the equivalent of \$20M in incremental sales (assuming the manufacturer has a 5% margin).
 - **Working Capital**—Deductions extend Days Sales Outstanding (DSOs) by up to 3-4X in some cases due to the extensive time to resolve disputes. Industry experts cite 105 days on average. Although manufacturers have not been paid in full by their customer (the retailer), they must still pay their direct materials suppliers and workforce. Brand owners must finance these “direct material costs” using their own working capital or seek 3rd party financing. Many manufacturers choose to fund these cash shortages with their own working capital. In such a scenario the supplier suffers an opportunity cost as the funds tied up in receivables could have been invested in other more strategic investments. Of course, if preventable deductions can be avoided al-
- together then the dispute process never starts. Invoices are paid in full (minus any planned deductions) and cash is applied quicker thereby lower DSOs. It simplifies forecasting and enables easier factoring.
- **Out of Stocks and Markdowns**—When goods are received in a distribution center that are improperly ticketed, packaged or documented, the merchandise may be held for days (if not weeks) before it is processed. For seasonal items or fast fashion SKUs with short lifecycles, there is a relatively short window of time for displaying the product to maximize sales. If a compliance infraction results in merchandise not reaching the sales floor in time, out-of-stocks may occur. Consequently, sales may be lower than expectation. With lower than forecasted sales, the retailer may need to use a markdown strategy to move the merchandise. And they may seek additional concessions from the supplier to support the lower pricing. All of these costs cannot be absorbed solely by the manufacturer, even if the root cause of many of the issues is with the supplier. The losses are inevitably passed onto the retailer and the consumer in the form of higher prices.
 - **Performance Scorecards**—Perhaps, the most significant financial impact to a supplier comes from the potential loss of business with the retail customer. Retailers not only track compliance for the purpose of deductions, but also for supplier scorecards. Performance across a number of order fulfillment, customer service and information technology criteria are tracked to rank or grade suppliers. Repeatedly poor performance metrics could result in lesser shelf space, reduced mind-share or discontinuation of purchasing by a major retailer. A \$500 deduction on a recent shipment is negligible in comparison to the potential loss of a \$500M per year account. The use of performance scorecards not only represents a threat, but it also presents an opportunity. Those suppliers which can eliminate the root causes of deductions will score high marks on performance reports. Servicing a retailer according to their unique needs enables a supplier to differentiate themselves based upon performance which can lead to increased mind-share, expanded shelf/rack-space and long term growth.

The Complexities of Compliance

Retailer compliance guides are extensive with 50-150 business rules each. Retailers track compliance towards similar types of performance criteria (e.g. on-time delivery, accurate documentation, carrier routing). However, there is very little consistency between retailers on the specific metrics being tracked. Consider that a supplier may have between 75 and 100 different retail customers each with different types of rules. You can begin to understand why complying with retailer-specific rules is quite challenging for even the largest suppliers.

The Vendor Compliance Federation (VCF) performed a study in 2006 of the compliance guides being utilized by 30+ retailers. The most frequent deduction category was “late shipment” utilized by 85% of the retailers. Consistency in measurement criteria typically simplifies processes for suppliers. However, even in the case of consistent performance measurements, differing interpretations of the results leads to further complexity. For example, there is widespread disagreement on how to measure whether a shipment is late. The Warehouse Education Research Council (WERC) conducted a study in the spring of 2005 to understand how companies measured “On Time Delivery” to warehouses and distribution centers. 42.7% believed that On Time Delivery means product delivered on the “requested” day. But the remainder of survey participants cited more specific windows:

- 16.8% stated “on time” is on or before the appointed time
- 15.9% stated “on time” is on the “agreed upon” day
- 11.2% stated “on time” is +30 minutes from the appointed time
- 9.1% stated “on time” is +1 hour from the appointed time
- 4.3% stated “on time” is +15 minutes from the appointed time

Not only do the definitions vary from retailer to retailer, but the supplier has little recourse to dispute a retailer’s claim that a shipment may have been early or late. Most suppliers are forced to use the retailer’s preferred carriers for shipment. Consequently, once the shipment leaves the supplier’s dock visibility is lost. The goods are in the hands of the transportation provider. Increasingly carriers are providing “electronic proof of delivery,” which helps to resolve disputes.

Another dimension which compounds the challenges associated with deductions is the fact that retailers make changes to the compliance guides. Some chains update the rules every 3-5 years. However, others publish changes 10-12 times per year. Some retailers will send proactive e-mail notifications to the supplier community while others will more passively post changes to a PDF on their vendor portal. In either scenario, suppliers must invest time to regularly monitor retailer communications and web sites for changes.

B2B e-Commerce and Complexity

How can technology reduce the complexity of managing deductions for retail suppliers? The logical place to address deductions would be in the manufacturer’s ERP system. However, many suppliers prefer to avoid making changes to ERP applications as they liken it to “ripping up concrete.” Consequently, a number of suppliers are turning to B2B e-commerce vendors which offer specialized cloud-based applications specifically designed to help with chargeback avoidance and deduction management. Many of the compliance violations can be identified in the electronic transactions being exchanged between buyer and supplier. For example, by examining the data in a purchase order, advanced shipment notice and invoice you can identify scenarios such as:

- Use of the incorrect transportation carrier as specified in the routing guide
- Advanced shipment notice arriving later than retailer requests
- Potential early or late delivery of shipment outside of retailer’s receiving window
- Mismatches between invoices, purchase orders and shipment notices
- Combining items from multiple POs into a single ASN
- Using a single ASN for shipments addressed to two different locations
- Unauthorized substitutions of a product different from the one ordered
- Over-shipment or under-shipment relative to the request quantity of goods

B2B e-Commerce vendors can model compliance guides using a set of configurable business rules. Once modeled, the

business rules can be applied to transactions in order to identify potential compliance violations. Ideally, a large sample set of transactions would be processed through the business rules to identify the most common compliance violations. The root causes of errors could be identified and then fixed using an iterative cycle until all known deduction causes have been removed from transactions.

Of course, if there is a mismatch between the actual physical shipment and the corresponding electronic records, then the data quality service will not be as effective. And there is a need for on-going management of the business rules. As retailers change their compliance guides, the associated business rules need to be kept up-to-date.



About GXS

GXS is a leading provider of B2B e-commerce solutions and operates the world's largest and most expansive network of integrated business communities. The company's software and services simplify and enhance businesses process integration and collaboration among networks of trading partners. Organizations worldwide, including more than 75 percent of the Fortune 500, use GXS solutions to extend their supply chain networks, optimize product launches, automate warehouse receiving, manage electronic payments and gain supply chain visibility. Based in Gaithersburg, Maryland, GXS has operations and offices around the world. For more information, see <http://www.gxs.com>, <http://blogs.gxs.com> and <http://twitter.com/gxs>.

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