# SPECIAL REPORT:

# PRODUCT RECALL



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# Speed is essential

## Testing recall mechanisms beforehand is key to a quick and effective response during a crisis

As supply chains get broader and companies are increasing the number of markets they export to, product recalls have become incredibly complex and costly exercises. In addition to the recall expense, there can be business interruption costs, loss of contracts, third-party liability and, of course, reputation damage. Meeting the requirements of multiple regulators can be a major issue, as regulators increasingly monitor what is happening in other countries and if a product is recalled in one territory, companies can expect regulators to react elsewhere.

The increasing complexity of product recalls is known as 'recall sprawl', explains managing director of the Sydney-based RQA Product Risk Institute Steve Hather. A specialist in the development and implementation of crisis management and risk management programmes, particularly in the food and beverage industry, Hather says companies are increasingly seeking to enhance their existing product recall and crisis management plans by adding sections relevant to specific export markets.

"For example, we assisted a client with a recall in Australia after recalling a product in the US. It was contacted by the Australian regulator and asked to conduct a recall of a product despite having no formal distribution systems here. The product had been imported by various small retailers and sold primarily online. Its fast response enabled it to build trust and enhance its reputation with consumers and soon after the recall engaged a local distributor to build its business here."

When conducting an effective product recall, speed is of the essence. In a world 'policed' by social media there is not much time to respond to an incident, advises David Goodall, head of Victual, a risk management and insurance advisory firm that focuses solely on the food and beverage industry. "When you talk about the hidden costs of a product recall, many people do not appreciate the management time absorbed by a product recall incident, especially if they have not gone through a crisis management scenario testing. Ensuring that you have appropriate risk management plans in place is critical, as is undertaking various forms of training and scenario testing on a regular basis."

### Reputation gamble

Hather believes that any company not testing its recall, crisis management and business continuity plans at least annually is gambling with its reputation and the long-term viability of the business. "The middle of a crisis is not the right time to find out your plans are less than adequate. The key management processes for teams to practice are those that, if done well, lead to effective recalls and, if done poorly, lead to crisis." These are investigation, assessment, strategy and communication. "Few companies test and practice these key processes in a realistic scenario," he warns. He adds that many companies choose to run 'mock' recalls, which are "traceability exercises that focus on the logistics of a recall".

Goodall confirms that in respect of supply chain, "traceability is king". "People need to explore and understand certain areas to ensure that they manage that risk appropriately. What kind of proportion does a supplier's business reprint to you, how diverse is your customer base, can your suppliers support you when you have upside opportunities and are they likely to be stretched during those circumstances because those are critical elements that could have a potential effect?" Traceability is about trying to obtain a clear understanding of the entire picture of your overall supply chain, Goodall adds. This includes utilities because they are as important as suppliers and customers. "It all comes down to business continuity management, which is critical to managing supply chain risk as well as product recall," he says.

As professor in operations and supply chain management at Cass Business School, ManMohan S Sodhi explains traceability is also important in respect of security. "Nobody would want to buy pet food that kills their pet – but that happened to some owners in California," he says. "Similarly, no one would want to feed their child contaminated baby milk, as occurred in China. Producers cannot have complete security and they cannot guarantee their products for consumers unless the raw materials they buy are completely traceable."

The 2013 European horsemeat scandal is a perfect example of how quickly public confidence can be rocked when firms lose track of their supply chains. Events began to spiral out of control in January, when horse DNA was found in some frozen beefburgers sold in British and Irish supermarkets. Public outrage prompted retailers and manufacturers to undertake tests, which revealed increased levels of contamination.

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The resulting scandal spread, leaving in empty shelves across the EU as products were withdrawn in 15 countries – this despite horsemeat not posing a risk to human health. More than anything, the contamination scare revealed a critical breakdown of traceability in the food supply chain and raised the possibility that other more dangerous elements could have been present – for example, the veterinary drug phenylbutazone found in meat from illegally slaughtered horses.

Sodhi says the real story was not that food labelled as containing beef had horsemeat adulteration. "Instead, the real concern is that even today, more than a year later, within the regulation-rich EU, retailers and food manufacturers will not guarantee even from what animal the meat in the food they sell originates. This is the case despite labels – as these are based on the information a company receives from its suppliers, which base the labels on the information provided by their own suppliers. In the end, no one can say with certainty what the end consumer is consuming." Someone, somewhere in the supply chain may be tempted to make substitutions, he adds. "This prospect has increased further because of the tight margins, which supermarket suppliers consider are ever narrowing. Thus, although genuine traceability for food is desirable it is unlikely to ever happen."

### Small investment

Nevertheless, Hather, who worked for The Coca-Cola Company for almost a decade, advises that traceability in the supply chain remains critically important for protecting consumer safety and managing the scope of a recall. "Let me give you one example of hard financial facts," he says. "We know a client that had reasonable capability in terms of knowing where its finished products went to. That is only half the equation, of course, as its ability to identify where its components and parts had come from was not great. When it encountered a problem with one small part that rendered the finished product unsafe, it knew this affected a small percentage of product... but which percentage? Instead of recalling one small batch, it had to recall the entire line, turning what should have been a US$200,000 recall into US$1m plus. For a relatively small investment it should have made in better traceability, it would have saved a lot of money."

A lack of understanding about the actual costs of a product recall is widespread, Hather laments. "What people often forget is that more than 30% of the tangible costs of product recalls is in business interruption costs. This can vary, of course, depending on the circumstances, but if you are out of business for several months because of a production problem that is difficult to resolve or a sole supplier that has a problem with a key ingredient – both of which have happened to companies within the past 12 months – you are looking at pretty significant costs."

## Effective strategy

Head of crisis management and vice-president of global casualty for AIG Nicky Alexandru agrees that many companies fail to recognise the true financial severity of a product contamination ahead of time. He points out that the three primary components of a major product contamination event include product recall expenses, business interruption and third-party liability.

"The expenses incurred by the manufacturer quickly escalate beyond recall costs, including the costs to provide replacement product to customers, loss of contracts with customers who find a new supplier, business interruption loss and brand damage during clean-up and remediation. This scenario can be financially devastating to the manufacturer."

Alexandru points out that as international supply chains continue to expand in complexity, so do risk exposures, increasing the likelihood of a product contamination. "Even plants with the best controls are at risk. Human error, mechanical breakdown or sampling failures can happen at any time. A mistake can also originate with suppliers of ingredients or packaging materials. New or unexpected contaminants are detectable only if specific tests are performed. Private label owners outsource production so they do not have direct control over the manufacturing and testing of their own products."

Another key cost frequently overlooked is the expense of returning to the market and rehabilitating the brand. Alexandru says: "Reputations for providing safe food are valuable assets that firms have an incentive to protect. The potential long-term damage to a brand can eclipse the short-term cost of recalling products. The cost of a significant contamination event can many times dwarf the costs associated with the actual recall of a product." Goodall views this risk area in a more positive light. "If you respond appropriately, it can have an upside and people have to be conscious of that as well, how we can actually add value. If you can put positive spin on things, it is amazing how your reputation can be protected and that is why it is advisable to have crisis consultants in place because they know how to communicate the appropriate message."

Insurance is also key, but as Hather says, "recall insurance should always be part of an effective product risk management strategy, not the strategy". "Insurance is a key part of your risk management strategy, but it should be considered as catastrophe cover to protect the company in the event of a larger-scale incident. Good insurers working closely with consultants like us look at partnering with their clients and brokers to improve systems and processes for preventing and managing incidents and recalls, which reduces risk for everyone."

Singapore-based Stephane Baldanoff, managing director of JLT's food and agribusiness practice in Asia, agrees that companies should view

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product recall as catastrophe cover. "They shouldn't rely on that to cover every recall or exposure they have. They need to have protection for a major recall that would cost them millions of dollars. If a recall is going to cost US$50,000 or US$100,000, they should manage that themselves. It's about reducing the cost of the insurance by putting it at a level where it becomes catastrophe cover – so where it will hurt their bottom line."

Baldanoff says it is important to go through contractual obligations and the regulatory environments in which a company operates as well as "how far up and down the chain it has visibility". "Does it know where its ingredients or components come from; where its product goes when it leaves its warehouse; how far up the chain can it monitor or trace its products?

"Then we talk about insurance; so how they can protect themselves, what the options are, and what kind of cover is available." This could involved an extension of a general liability policy as a starter to cover recall expenses to a full standalone product recall contamination policy. "The extension is a good way to start, but ultimately [this needs to lead] towards a proper standalone policy that includes contaminants, malicious product tamper and so on."

Alexandru says that working with a risk management partner with deep experience in this area can help companies better understand potential product contamination exposure (the impact of retaining exposure on the balance sheet versus the risk transferred via insurance, captives or other means) and better manage third-party volumes or contractual indemnity provisions (by measuring the contamination risk at the supplier or contract manufacturer level). "The more food and beverage companies understand their potential financial risk, the more informed decisions they can make about how to protect their customers, supply chain and bottom line."

## Buyer beware

However, Goodall advises, policy coverage comes in various forms and "it's a case of buyer beware". "You certainly need to understand what the intent is of an insurer's policy and a good exercise is to go through various claims scenarios to stress test the various policies available," he advises.

"That is a critical exercise to undertake because it's amazing how many clients are purchasing insurance they don't understand; they've never seen the policy wording or never spoken to the policy underwriter."

What is certain, Goodall asserts, is that if a company has thorough and extensive business continuity management plans in place, "insurers are going to be much more comfortable that the organisation will manage a recall a lot more efficiently than one that doesn't have a business continuity management plan in place". "That should be reflected in the premium and coverage they provide," he adds. **SR**

# Cost issues

## Businesses now know that the cheapest option may be a mistake in the long run

ASIAN SUPPLIERS WILL find that Western customers increasingly demand that improved product recall, business continuity and crisis management processes be put in place and that these become integral parts of supply contracts, says Steve Hather, managing director of the RQA Product Risk Institute.

"Decisions on suppliers used to be based on cost, but companies now better understand the true cost of risk and that the cheapest supplier may not be the cheapest if they end up in a complex recall affecting their reputation. They may be able to claim back the product costs, but reputation risk is a much more costly thing to restore."

Hather says that suppliers that have effective quality management systems as well as product recall, business continuity and crisis management systems in place are showing they take their responsibilities seriously and can be relied on as a long-term partner. "We see many more large retail chains for example requiring suppliers have [these] processes in place and tested. The message is clear – any Asian company that wants to be a player outside their own domestic markets need to get their plans in order."

There is a clear link between a strong regulatory environment and effective product recalls, Hather says. "Countries such as Malaysia and Korea are leading the way with support from organisations such as GS1 and initiatives like the ASEAN Recall Portal, so consumers and regulators can see what is recalled in other countries. Consumers in APAC countries are entitled to demand manufacturers and retailers produce a safe product and have effective processes in place to recall them it they are unsafe."

Managing director of JLT's food and agribusiness practice in Asia Stephane Baldanoff believes that as more Asian companies become food ingredient component suppliers to Western food companies, they need to understand where their raw ingredients come from to manage their own risks. "A lot of the companies, whether it's in China or in South-East Asia, are just not aware of their obligations," he says. "There is also a lack of awareness of the expense a major recall exercise can be to a business. They don't understand that if they're a component provider there could be a third-party recall by the ultimate product manufacturer and they can send them the bill for it." **SR**

# Changing attitudes

## Learning from past mistakes is essential

If an industry is going to manage risk better, mistakes should be acknowledged, says head of risk and insurance advisory firm Victual David Goodall. "People don't want to highlight their deficiencies, but everyone can learn from experiences, including insurers, particularly regarding gaps in policy coverage. They need to share how they've rectified internal policies and procedures to prevent similar circumstances arising again." Here are four recent examples of product recalls:

- A beverage company that packaged and distributed coconut water received unprocessed coconut water from suppliers in Thailand. The imported coconut water was pasteurised and sold without artificial additives or preservatives, thus considered to be 'all natural'. Customers reported the product was fermenting and had a bad odour and flavour. Natural bacteria were found in the spoiled product. An investigation determined the pasteurisation process was not adequate as an effective kill step and that the bacteria could result in illness for some consumers.
- At least 250 people became ill after consuming a ready-to-eat processed meat. Open containers of pepper had been contaminated at the meat manufacturing plant. One of the pepper suppliers was determined to be the source of salmonella, resulting in a nationwide recall of affected seasoning and gravy mixes, soups and chilli. The dried mixes and soup manufacturer incurred losses in excess of US$3m for recall expenses, rehabilitation expenses and third party recall damages.
- During routine quality assurance testing, a soft-drink manufacturer discovered unusual taste and smell in a product. Two holes inside the cooling system had resulted in ammonia contaminating the beverage before it was bottled. The contamination meant there was a risk of exploding bottles and personal injury. Although the ammonia affected less than 10% of the inventory, estimated damages were US$1.4m, including stock replacement. The main loss components were disposal costs and loss of profits.
- A contract seasonal picker was found to have typhoid fever a few days after he began harvesting kiwi fruit for a fruit producer. The company immediately destroyed fruit worth more than US$1.1m that this worker might have been in contact with to avoid the possibility that someone in the supply chain might contract this infectious disease. **SR**