Reverse Logistics: Backwards Practices that Matter

McKesson Corporation
Case Study

Site Visit Date: December 15, 2006
Site Visit Location: Carrolton, Texas

Site Visit Host:
- Scott Bradford, Vice President, Reverse Logistics
I. GENERAL OVERVIEW

McKesson is the largest pharmaceuticals distributor in the United States, with reported sales of $80 billion. The pharmaceutical distribution business delivers pharmaceuticals, health and beauty care products, medical supplies, and equipment from more than 30 distribution centers serving the United States.

Significant profit leaks and associated costs on returned products prompted the organization to become more process-driven rather than functionally segregated. Due to the buy-and-hold inventory model in the pharmaceutical wholesale industry, wholesale customers had incentives to buy surplus inventory in anticipation of price increases on pharmaceutical products. Higher inventory levels led to a significant number of returns; as a result, reverse logistics absorbed the losses on the back-end processes. Furthermore, a decentralized reverse logistics strategy created process inefficiencies and financial losses as McKesson managed multiple return processes and supplier returned goods policies.

Reverse Logistics Overview

McKesson developed a reverse logistics initiative to support key organizational goals to maximize product recovery value and increase profitability. Goals to reduce costs and cycle time also drove the initiative. Additional customer-oriented goals include increasing customer responsiveness and service while minimizing discrepancies. Results in these areas are achieved by implementing effective reverse logistics processes and asset recovery practices, as well as understanding returns operations costs. Reverse logistics velocity; visibility/traceability of returning goods; and positive practices to avoid returns, including product improvement and innovative practices, also contribute to key goal achievement.

McKesson’s reverse logistics policies and process accountability involve cross-functional stakeholders including finance, procurement, operations, sales and marketing, and customers. Scott Bradford, vice president of reverse logistics, manages returns policies, stakeholder relations, and reverse logistics strategy execution.

Final disposition of returned product is made at McKesson returns management centers. Ninety-five percent of returned product is restocked and resold through the primary channel, achieving the corporate goals to service its customers.

McKesson is centralized; much of the distribution-center management and functions are conducted from a central location. It is driven by functional owners like sales, operations, and inventory procurement.

Customer returns to McKesson are primarily the result of inventory management as opposed to defects. The organization sees:

- customer error (e.g., a pharmacy intends to order one vial of product and instead orders a carton of 25 vials),
- overstocking (e.g., the pharmacist or chain ensures product is available but the patient who requested the product never buys it), and
- demand changes (e.g., product goes generic or formulary changes).

McKesson’s reverse logistics organization is located in Carrollton, Texas, as part of the organization’s financial service center, which handles several back-office, procurement, and customer support operations.

Bradford reports directly to the vice president of supplier processes, who reports to the general manager of the financial service center organization. The supplier processes group primarily manages the transactional relationships that occur between suppliers and the organization.
Bradford says that positioning the group in supplier processes was not an “exact science.” Reverse logistics’ current reporting relationship is primarily for human resource management, alignment with procurement and customer support operations, and supplier management. He says, “Although there may be a logical place for reverse logistics to be located in your organization, I could make a case at McKesson that we could report to procurement or operations. We could fit in with a lot of organizations.” The group currently enjoys the physical location of Carrollton, given the proximity to McKesson’s primary reverse distributor, and interacts extensively with other areas of the organization that are located in the facility.

Reverse logistics does not operate under a formal matrix, but it does collaborate closely with procurement/product management, field operations, and sales. Bradford says, “I will tell you that over time, because of the relationship building, there are literally dotted lines throughout the organization where we will be providing services and involved in initiatives. If you have a returns question, project, or initiative, you should sign up a person from the reverse logistics group to be on your team.”

The reverse logistics group owns the return policies and processes, manages outsourced activities, and processes all manufacturer return credits for McKesson and its customers.

Customers return products to McKesson warehouses using an automated process in the organization’s warehouse management system, Acumax, and SAP, an integrated ERP. Most products are immediately restocked and sold. The organization has centralized returns through a reverse distributor. Customers often return products directly to the reverse distributor, bypassing McKesson altogether.

McKesson owns and manages the returned goods policies, which are documented in supplier/customer agreements. The organization has centralized transaction processing of manufacturing credits in its Carrollton office. It creates, markets, implements, and supports value-add customer programs through reverse distributors.
II. REVERSE LOGISTICS STRATEGY DESIGN

Today, reverse logistics is a process that crosses many functions and disciplines throughout the company. It was a pioneer process in terms of integration; part of a new dynamic for McKesson starting about five or six years ago.

—Scott Bradford, vice president, reverse logistics

The transformation of the reverse logistics process had four primary objectives.

- Simplify the process for the organization’s distribution centers and the customer pharmacies.
- Promote a secure supply chain; The organization needed to assist the supply chain partners in the proper disposal of products.
- Improve asset recovery and mitigate costs. The organization was seeking ways to avoid duplication in the supply chain.
- Develop expertise within McKesson and educate internal and external partners (reverse distributor partners, suppliers, manufacturers, and McKesson employees).

McKesson dubbed its integration of reverse logistics into other areas of the organization “The Journey.” As Figure 1 shows, The Journey affected several reverse logistics processes during its tri-phase rollout. Specific catalysts drove transitions from one phase to another.

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In 1994, the catalyst for the initiation of Phase 1 was a senior vice president of operations who commissioned a feasibility study for outsourcing over-the-counter expired returns by removing a variety of functions, such as accounting and returns to suppliers, from the distribution centers. He successfully presented a business case and selected a reverse distributor, USF Processors (now Carolina Logistics Service [CLS]). The outsourcing initiative was funded with headcount reductions and the industry-standard practice of charging suppliers disposition fees. A single employee implemented the process and negotiated with suppliers. In 1994, reverse logistics was no more than a function or activity,
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...and outsourcing was merely a cost-reduction initiative. It was primarily shifting workload to a third party. Although reverse logistics was somewhat integrated with the accounting/inventory group that supported it, it was only slightly integrated with other McKesson processes. The value of the outsourcing initiative was not fully recognized, as leadership was minimally aware of its comprehensive financial impact. Additionally, no one focused on faults with the return process (e.g., costs incurred when returns were damaged in transit or returned to suppliers outside their returned goods policies). However, in time, the initiative successfully created a reverse logistics function within the organization.

After successfully outsourcing over-the-counter returns, the organization began outsourcing its prescription product returns, strengthening the partnership between McKesson and the outsource provider. Because of the increased value of the returned products, the dependencies on process integration between the two parties grew, and the firms began to communicate more frequently.

When McKesson rolled out Six Sigma in 1999, some of its initial projects addressed the aforementioned inefficiencies that had previously existed, but process improvements were not sustainable. These quick-win opportunities boosted the applicability of integrating Six Sigma into the reverse logistics initiatives.

Phase 2 began in 2000 with the creation of a more comprehensive profit and loss (P/L) statement. At the time, McKesson was reporting and writing off extensive high-level losses known as debits disallowed, which covered returns and their disposition. Positions were created for a full-time manager and two analysts to examine the financial impact of outsourcing returns and quantify losses for product disposition. The group began to standardize distribution center processes and use Six Sigma resources to make improvements. They held frequent conversations with other organizations to put standard operating procedures (SOPs) in place.

During Phase 2, reverse logistics became better integrated with other parts of the organization affected by returns and began to conduct Six Sigma projects at the outsource provider’s location.

Bradford says that having a full-time manager responsible for reverse logistics was a key to success. Before the manager was in place, everyone in the organization had difficulty determining where to go with their questions—they did not know whether to call sales, operations, or accounting.

In 2002, reverse logistics was heavily involved in the blueprint and design of the SAP sales and distribution module. The group worked hand-in-hand with the SAP team in training and implementation.

In Phase 2, reverse logistics became a functional group, located in Carrollton, although it reported through San Francisco. The Carrollton facility was primarily a financial service center, but also included procurement and other sales support functions. Due to the proximity of several internal partners in Carrollton, reverse logistics was becoming accustomed to operating virtually and establishing natural dotted-line relationships with finance, sales, and procurement.

Reverse logistics conducted some public relations work to educate the organization on its role. Its visibility has also been aided by having representation when major initiatives are discussed. It began having annual meetings with the sales and operations teams. During Phase 2, reverse logistics became a new entry in the monthly financial reporting that the leadership team generated at the Carrollton site.

In 2002 reverse logistics focused more attention on customers. It examined the customer experience and enhanced standard returned goods procedures and policies. Bradford says, “We worked with our internal business partners to create a more standard return policy.” The team developed the templates, communicated with external partners, set standards, and changed dynamics. In 2003, reverse logistics and procurement announced...
a McKesson Returned Goods Policy to its suppliers in an effort to bring more standardization in managing the multitude of unique return policies for expired pharmaceutical products.

As Phase 2 drew to a close, reverse logistics continued to integrate processes with other key functions. The increased affect of reverse logistics on other parts of the enterprise prompted senior management to create the reverse logistics organization.

Reverse logistics played a role in multiple enterprise-wide projects including the Sell Side/Buy Side initiative. SAP process flows and McKesson organization resulted in a focus on sell side and buy side strategies: The buy side included purchasing and paying invoices; the sell side involved customers and the order-to-cash process. Reverse logistics conducted conversations with internal business owners concerning customers and suppliers regarding process improvement and profitability. The team helped track initiative improvements and savings with both strategies.

Whenever McKesson customers or suppliers enter into agreements that include return policies, reverse logistics either approves or provides input into the documents. Bradford says that reviewing these agreements "is a large part of what we do. It is an opportunity to exert much influence in the business balancing collaborative partnership and financial impact."

During phases 2 and 3, reverse logistics has been able to conduct various improvement projects because it is able to correlate project results with hard-dollar savings. These projects served to reduce costs and plug profit leaks that saved the organization millions of dollars annually. Through its excellent relationship with CLS/MedTurn, reverse logistics has been able to receive approval from suppliers to destroy products at the outsource provider’s site so that shipping the product to another party is not necessary.

Phase 3, which is ongoing, focuses on the customer; reverse logistics determined it could add value that customers would pay for by quickly and efficiently accepting their expired returns and issuing manufacturer credit. Reverse logistics created a turnkey solution for customers—it worked with departments, manufacturers, and customers to set up systems to handle all aspects of returns. The turnkey programs are completely funded, marketed, and supported by the reverse logistics team.

Reverse logistics also integrated transaction processing into the organization and developed a sales program that was applicable to prospective, new, and current customers. Reverse logistics fostered relationships with multiple reverse distributors to develop programs for specific customers (e.g., national retail, independent, institutional, and government). To encourage sales people to discuss the new expired-product return program with retail independents—which have a variety of options for handling expired products—reverse logistics offered them a monetary incentive for two consecutive quarters in 2005. Soon, reverse logistics was contributing to McKesson’s EBIT (earnings before interest and taxes).

In addition to improving the returns process, reverse logistics began to look upstream to determine the root causes for returns. These could originate with the manufacturer, the warehouse, the ordering process, etc. Reverse logistics was able to engage in projects with other functions (e.g., procurement, operations, and inventory accounting) to address some of the problems and increase customer satisfaction. As a result, the percentage of returns to suppliers as a function of sales has decreased significantly; sales have increased consistently for the past four years, while return volumes have remained relatively flat.

The enterprise-wide dedication to process improvement is continuing to increase, and process improvement is conducted throughout the reverse logistics organization. McKesson’s Six Sigma Green Belts facilitate process improvement by spending 20 percent of their time involved in one or two reverse logistics enhancement projects per year.
Twenty-two of the 26 reverse logistics employees are directly involved in transaction processing (i.e., issuing manufacturer credit to McKesson and its customers) or customer support for the return programs. The workforce is a combination of two McKesson teams: one focused on transaction processing and one to provide customer service and interact extensively with McKesson’s reverse distributor partners. These employees do not focus on the automated customer returns to the distribution center, because these processes are highly automated.

As part of the Phase 3 activities, reverse logistics participates in an at-risk inventory process with personnel from finance, accounts payable, inventory procurement, and product management to identify excessive inventory or problematic suppliers (e.g., those who owe McKesson money). The team meets monthly to concentrate on specific suppliers and determine how to limit McKesson’s financial exposure.

Continuing focuses of Phase 3 are process and data integration with reverse distributor partners and integrating reverse logistics initiatives into other functions.

III. Establishing a Physical Reverse Channel

McKesson’s reverse channel deals with four primary types of products: expired products, returns from customers, missed shipments/undeliverable products, and missed picks and overage/shortage resolutions. McKesson channels most expired product (both over-the-counter and prescription) from their distribution centers through MedTurn/CLS. This reverse distributor segments the products and determines whether to send them back to the manufacturer, to another reverse distributor, or to an area where they can be destroyed. Returns from customers are primarily restocked and sold to other customers. The most significant exception involves product recalls and withdrawals: McKesson receives recalled products, issues credit, and follows the manufacturer’s policy regarding disposition. Missed shipments and undeliverable products are returned to the distribution centers, not reverse logistics, and operations is responsible for managing this process. Missed picks and shortage/overage issues are not completely automated. Pharmacists and health care providers with these issues contact one of the centralized customer service centers, and customer service along with the distribution center investigates the matter and issues appropriate credit to the customer.

Customers receive credit for expired products directly from the manufacturers or from their wholesalers. Customers may return expired product directly to the manufacturers, reverse distributors (returns provider), or their wholesalers. If an expired product from a customer does not meet the manufacturer’s policy for return, or if the manufacturer requests that McKesson not take back expired products through the wholesaler, then the McKesson system blocks the creation of the return authorization and does not issue credit for such products. Customers are notified that they will need to work with or return through the manufacturer. With few exceptions (such as private-label returns), McKesson does not assume financial liability for its customers regarding non-returnable expired products; generally, the organization receives the product only when its costs can be recovered through the manufacturer.

The organization requires return authorizations from customers. When the customers order from McKesson, they have Web-based, hand held device and pharmacy-terminal ordering systems. All returns go through the same technical process by which ordering is done.

Because of the agreements with customers, high returns may not necessarily translate into lower profits for McKesson: The organization charges a handling fee to restock the product. The product is not devalued; customers receive full credit. Generally, if a customer purchases and returns a product quickly, a handling fee is not charged.
Returning Pharmaceuticals

Although McKesson also distributes over-the-counter products and other supplies, its ability to properly process pharmaceutical returns is critical. For this reason, the pharmaceutical products and distribution processes drive the return strategy.

The process of returning pharmaceuticals is complex because:

- different types of customers require various return processes;
- McKesson works with more than 500 manufacturers that have a variety of processes to support their returns; and,
- the return flow is physically complex, with several hand-offs. McKesson has contracted drivers who take the products back to distribution centers, and from there, the products flow to the reverse distribution partner facilities.

Errors and defects in pharmaceutical distribution are exceptionally costly. According to Bradford, “You can hold several thousand dollars of product in the palm of your hand; $100,000 can be carried in one or two cases. Only a few mistakes can have a substantial financial impact.” McKesson suffers financial loss when the products expire or if a short time remains before expiration because the organization cannot distribute these pharmaceuticals. For these reasons, reverse logistics represented a great recovery opportunity and was elevated from an initiative to an organizational focus.

Incinerating unsaleable products is standard within the pharmaceutical industry; however, the industry does not currently have disposition and reimbursement standards and is only beginning to standardize the steps that precede incineration. Therefore, McKesson developed processes that make good business sense and best utilize resources rather than duplicating its processes in every distribution center.

Reason Codes

When products come back to the McKesson distribution center, the return authorization process requires the customer to select one of approximately nine reason codes. At the distribution center, McKesson employees validate or change the reason code and add one that more accurately describes the product's condition, which may include the available dating of the product, the type of damage that a product has undergone, or other factors. The product is either restocked or goes through reclamation at the distribution center and later forwarded to an outsourcer provider (MedTurn/CLS,) for return to supplier or final disposition.

McKesson and its customers have set reimbursement and fees for the automated reconciliation process; however, this is not the case with reconciliation between McKesson and manufacturers. McKesson does not keep a history of price changes, so reconciliation variances may arise with the manufacturer regarding product receipt dates and the price at the time the returned product was purchased, if the manufacturer reimbursement policy is tied to purchase price.

Returns Processing in the Distribution Centers

Reverse logistics is the process owner for returns handled by the distribution centers. Each of McKesson’s distribution center regions has a vice president of operations. In 2003, one of them accepted the responsibility of owning the execution of the returns process for all regions. As vice president of reverse logistics, Bradford focuses on policy, financial impact, process, and systems, while the vice president of operations focuses on execution. The vice president of operations works closely with reverse logistics to develop and document standard operating procedures and ensure that the distribution centers are meeting ever-changing federal and state regulations.
Inspections

Inspection is a step in the returns process, and McKesson rigorously inspects its product returns. The return process is “first in, first out” and mirrors a receiving process. The typical return is not a full pallet of goods but totes of product that may include cases and individual selling units.

If a product reaches the loading dock without a return authorization, the distribution center will contact the customer to initiate a returns authorization or return the product to the customer. If returned products have price stickers, they may be returned but will be deemed unsaleable and moved to reclamation. McKesson is becoming more selective in accepting refrigerated returns; for safety’s sake, after conducting research and comparing previous storage conditions to those required by the manufacturers, McKesson places products that may have been compromised into reclamation.

Transportation

Customer returns to the distribution centers are typically handled by drivers who deliver orders daily and who are paid per stop. Because drivers pick up and deliver to multiple locations as part of their jobs, minimal additional cost is incurred by McKesson for them to bring the products back to the distribution centers.

Customer returns for controlled substances are often shipped via UPS and Federal Express Ground direct to the distribution centers to promote a more secure supply chain. These carriers are able to handle controlled substances (e.g., narcotics) that require the exchange of C(2) forms.

Many customers use third-party reverse distributors to ship returns; returns are packed in Owens/Brockway and other vial boxes and shipped through UPS, Federal Express, or another carrier.

Rules regarding transportation of the returns from the distribution centers to the manufacturers vary, but transportation is often paid for by the manufacturers, especially when the products are damaged or recalled.

Monthly, McKesson sends returned products received in its distribution centers to MedTurn/CLS (Fort Worth area) in the most cost-effective way possible—full truckloads making multiple stops and LTL (less-than-load) contract carriers. Transportation from distribution centers to the MedTurn/CLS represents the organization’s largest transportation cost for the reverse logistics organization and Bradford says that McKesson’s transportation team and distribution centers have fine-tuned the process somewhat; however, most of the cost is unavoidable.

Communications/Engagement

In order to maintain continuous communications and standardized processes, one reverse logistics business analyst, selected due to her experience in distribution and inventory management, operates as a field liaison and a subject matter expert for inquiries from other areas of the organization. She conducts site visits and has periodic conference calls with the distribution centers to help them understand new processes. She communicates constantly through e-mail with distribution center–based employees who are executing the handling of returns. She analyzes reverse distributor data and ensures the compliance of the distribution centers to standardized procedures. Her position has been key to the organization’s success because it encourages consistency, standardization, and knowledge sharing.

McKesson also developed a strategy to centralize communication of financial results and to require reverse logistics to engage other critical business partners. This required various
methods of communication, which required periodic conference calls, monthly reporting to senior management, and integrated in budgeting process.

Monthly, reverse logistics presents and reports to the Carrollton leadership team and corporate reporting on “other cost of goods,” which is a stand-alone section of the P/L. Reverse logistics does not impact on every line item, but it is responsible for communicating and reporting results from a corporate perspective. Additionally, it is working with the other departments to identify opportunities, influence behavior or recommend policy changes that positively contribute to the P/L.

The pharmaceutical industry operates under pedigree laws that ensure drugs are not counterfeit. McKesson, as a wholesaler, is an authorized distributor of record for most of the items that it purchases from the manufacturer. In some cases—for example, when the product is not received from a manufacturer—the organization is required to generate the pedigree. Because the wholesalers are not set up to track lot numbers and expiration dates, the industry is facing some challenges in meeting legal requirements. Bar coding and other electronic tracking at the product level cannot currently be done systemically and automatically.

In 2006, many states initiated or revised their pedigree requirements, so reverse logistics participates in many of the McKesson-wide conversations regarding how to handle pedigree issues during product return and restocking.

Customer Service

Before reverse logistics created its own customer service team, returns to manufacturers and third-party reverse distributors and credit inquiries required a handoff to reverse logistics. Since these returns from customers were not physically handled in the McKesson distribution network, general service agents did not have the expertise necessary to work directly with the manufacturers or third-party providers to address customer inquiries. Now, these customer service issues are communicated directly to the reverse logistics team, and associates work the problem from beginning to end.

Reverse logistics' customer service team logs and tracks all calls. Not all customer service questions can be answered immediately; therefore, through an internal service-level agreement, reverse logistics commits to its internal and external customers that it will provide them with a status report within 72 hours of receiving the call. Even after 72 hours, the question may require further work, but the customer is kept apprised of the status.

Pharmacy calls present special challenges because pharmacists are often not the ones who make the inquiries regarding returns. Customer service associates are required to spend considerable time coaching the caller to provide the information necessary to track returns and credits. They are contacted by customers by e-mail and by the phone.

Reverse logistics and MedTurn/CLS have joint e-mail accounts so that customers can call either MedTurn or McKesson and receive seamless solutions to their problems.

IV. ENABLING PROCESSES AND OPERATING SYSTEMS

Through its uses of SAP and Acumax, McKesson has integrated and automated returns with its customers. Integration between the organization and MedTurn/CLS is partially integrated. Each partner has warehouse management systems and financial/reporting systems. For example, the outsource provider and third-party reverse distributors often capture vendor name and number and supplier name and number differently than McKesson does. Employees often rely on EDI, XML, and Excel spreadsheets and databases to translate from one system to the other.

To bridge the systems gap, reverse logistics makes extensive use of analytical resources and databases. It reports the compliance of the distribution centers and how well they are
working with the outsource providers and other partners. The team concentrates on employee training and values its long-time employees who know the business inside and out. It understands that documentation is important because, according to Bradford, “You cannot integrate everything into a system. You cannot build a business rule for everything. You cannot build an interface where you would like to.” Finally, it relies on Six Sigma expertise to measure, define, and implement controls to improve the process.

Sarbanes/Oxley has created a need for rigorous control of any information that McKesson receives from its customers, outsource providers, or third-party reverse logistics organization. McKesson is currently conducting a project that is building additional controls into the integration of external data and spreadsheets so that it can be sure it receives the right information every day and correctly accounts for the financial transaction. Validity is needed from both an internal and an audit point of view. Although it calls on some resources for assistance, reverse logistics is ultimately responsible for its sign-offs documentation, testing, and narratives.

**Overcoming Constraints**

When SAP design began in 2002, reverse logistics and the project team struggled to make the transition as seamless as possible for the customers and to maintain the native functionality of returns in the sales and distribution module.

McKesson accepts orders throughout the day using different cut-off times and picks products at night. Because of the large volume of transactions, the organization is challenged to run invoices and pick during the night. The timeline constraint affects the entire system and disrupts the cycle time of transmitting return authorizations, pricing the returned product, and approving and returning authorizations to the customer. Reverse logistics worked with the SAP team to overcome the competition for resources between timely invoicing of customers and performance of key daily functions, such as authorizing returns.

Reverse logistics did not have to change its core processes to implement SAP, but it did change some other processes. Determining the proper business rules for pricing returns for the customer, while ensuring SAP performance requirements, was extremely important. SAP could not accept the volume of information necessary to produce an invoice reference and allow a return to be priced. Reverse logistics had to create an additional data table within SAP that held the information necessary to price the returns in time to make the cut-offs.

Data flow is not integrated in the supply chain for expired returns back to the manufacturer. Electronic data is not interchanged from the beginning to the end of the chain. Customers receive a certain set of data, manufacturers receive another, and the reverse distributors receive a third set.

**IV. Measurement, Results, and Continuous Improvement**

*We had to prove tangible benefits. If we had not been able to demonstrate tangible, hard-dollar savings in large dollar amounts, we would not have been able to accomplish what we have. I would not be talking to you today. We benefited from the problems that existed previously, but it took some measurement and recording to make our case.*

—Scott Bradford, vice president, reverse logistics

As Bradford describes, “[McKesson has] one business owner for the reverse logistics area. We don’t control everything in returns, but we are its sole owner.” Organizationally, McKesson has one process owner for all return activities, including the collection of return
Reverse logistics has extended the reverse logistics strategy to provide customers with more efficient processes and improve recovery on expired prescription returns. Internally, other McKesson subsidiaries such as specialty distribution businesses have adopted the returns model established by reverse logistics.

Reverse logistics has been involved in a multitude of projects since 2000. They include:

- developing reclamation processes to prepare for disposition,
- mapping MedTurn/CLS processes,
- standardizing recall policies and fee billings,
- preventing damaged products,
- handling non-returnable products (upstream ordering),
- maintaining manufacturing return policies, and
- shipping class of trade for product liability.

Some saved the organization millions of dollars, and others simply created a baseline from which to measure improvement.

Key Metrics

Reverse logistics measures and manages to five key metrics:

- **percent of reclamation to inventory on hand**, defined as ($) inbound to reclamation/average total inventory ($);
- **customer returns rate**, defined as ($) customer returns to the distribution centers/($) of customer purchases;
- **returnable percent of expired returns**, defined as reclamation returns meeting manufacturer return policy as a percent of total reclamation returns;
- **collection rate on McKesson returned product**, defined as ($) manufacturer credits collected/expected value of returned product; and
- **reverse logistics**, defined as P/L (other cost of goods). Reverse logistics considers this the most important metric.

The distribution centers are measured on cycle time to issue credit and reclamation percent to inventory. Sales is measured on returns as a percentage of sales. Measures are visible at a high level in the organization, but they are not currently providing continuous reporting to, address customer- or manufacturer-specific problems.

Measuring to Prevent Returns

McKesson’s promise to customers is that they will have the products that they need when they need them. This proactive practice creates a tendency to overstock. Pharmacies also have a tendency to overstock because product omissions can result in unhappy—or lost—customers. Pharmacies have a natural range for overstocking products as well, thus the sales team works with customers to educate them to better manage their orders to avoid penalties and lower the rates of returns.

McKesson measures return rates; return percentages vary by segment of product and customer. Its overall blended return rate compared to direct pharmacy sales in dollars is approximately 2 percent. The overall blended sales return rate in units is slightly higher because over-the-counter products have a low line extension.
The organization concentrates on measuring returns, but it has not made this a focus for all customers. Determining root causes for returns is provided for customers that consistently return product at a high rate. According to Bradford, an opportunity exists for sales or distribution personnel to educate the customers that fall into the normal range of returns on how to reduce them. Although sales agents are compensated for direct sales net of returns, other sales initiatives and program compliance take precedence in priority and weighting for compensation.

Results

Figure 2 shows EBIT improvement of reverse logistics, as a year-over-year percentage. It demonstrates that the team has been able to increase its financial contribution to the enterprise by approximately 80 percent annually through asset recovery and expanding its footprint into customer facilities by offering special programs.

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**Figure 2**

Employee Incentive

Reverse logistics is able to fund part of the Carrollton facility–based gainsharing program—when the facility exceeds it budget commitments, many Carrollton exempt and non-exempt employees are rewarded through a gainsharing payout that could exceed 5 percent of their salaries. (Gainsharing is not available to employees who are eligible for other types of bonuses.) Specific line items in reverse logistics’ P/L have a direct impact on payout. The group contributes both to the funding aspect (through income that it adds) and to the payout (through a combination its production metrics or income that it adds). Gainsharing has been in place since 2003 and has failed to pay out in only a few quarters.
IV. LESSONS LEARNED AND LOOKING FORWARD

The returns process requires flexibility and adaptability. Few standards currently exist, for example, in reimbursement, disposition, and EDI transactions, and regulations are constantly changing. McKesson has occasionally created its own policies and processes because it believes, as Bradford explains, “Sometimes you have to do what is right for the industry, set a course, and hope others will follow.”

Looking back to when he first arrived at McKesson, Bradford says he would have liked to have spent more time in the distribution center to understand the details of accepting returns. He would have engaged more strategically with the procurement area to better understand the drivers for returns and influence its policies with manufacturers. He also might have hired more analysts so that reverse logistics could have plugged profit leaks more quickly.

The reverse logistics team reports the following lessons learned:

• The reverse logistics organization should be visible. The executive who hired McKesson’s first reverse logistics manager was well-respected; he was prominent in the Six Sigma organization and had extensive operational management experience. Bradford says, “I had a great champion.”

• Reverse logistics should demonstrate tangible value to its stakeholders and internal/external customers.

• Reverse logistics should be involved in key enterprise-wide initiatives and technology enhancements. Reverse logistics was created just in time to have a voice in the design and deployment of enterprise-wide technologies. It influenced policy and systems requirements.

• Having a process-focused organization helps to gain buy-in because reverse logistics processes impact multiple functions and departments. Although reverse logistics is not a large organization, it leverages and calls upon resources throughout the enterprise.

• The business model should be integrated with outsourcing partners such as reverse distributors. At inception, the outsourcing of returns was not a popular idea. However, over time, management has seen the value of the relationship.

• Reverse logistics should measure, measure, measure.

The team reports the following lessons learned from its outsourcing relationship:

• Selecting an outsource provider partner is critical and valuable. The partner must be willing to change its processes and have adaptive technology and reporting systems; it must align its goals with organizational goals. MedTurn/CLS is willing to change its processes and learns from McKesson how to improve its services both to McKesson and its other customers.

• Outsourcing requires focus on the process. Bradford explains, “Outsourcing a process does not mean you are not responsible for it—you are probably more responsible for it.” Communication between McKesson and MedTurn/CLS is strong—as many as 15 McKesson employees have direct, ongoing contact with the outsource provider.

• Organizations must understand themselves and their partners. Gaps in data and systems will always exist, and the partners need to translate data so they can communicate well.

• Assigning dedicated people improves payback; opportunities require investment of time and focus.
Measuring success is important; organizations must develop a scorecard and review it regularly.

Future Challenges

Reverse logistics is facing continuing challenges, listed below.

- Integrating systems throughout the supply chain. Supply chain functions make little use of EDI and standard data sets.
- Integrating systems with the reverse distributor. Work continues on creating master data, unit of measure conversion, etc.
- Managing change regarding the outsourcing of returns. The preference of some employees is to keep a process in house, but the business case proves that the organization is better off letting the outsourced partner perform the activity.
- Smoothing the process of handling expired product. The current process entails multiple handlings, which create defects and extend cycle times;
- Balancing reverse velocity. Speed is important to the customers and McKesson for product that can be restocked, and
- Minimizing liability. Although reverse logistics is successful in minimizing liability, changing regulations require constant adaptation. Various states are passing pedigree laws that make restocking returned items more difficult. These laws have requirements and restrictions on what items can be re-sold.

Bradford believes that counterfeiting is real challenge in the pharmaceutical distribution industry. The industry cannot efficiently track lot numbers from receipt of product from manufacturers through shipping and returning of products for all customers. In the future, RFID (radio frequency identification) will allow wholesalers and supply chain partners to account for product down to the individual bottle or vial. RFID adoption and implementation will provide much better tools to identify and track counterfeiting efforts. Even with lot tracking capabilities, all supply chain partners who handle and return product will be subject to counterfeiting by criminals who dilute and repackage medicines.

McKesson’s reverse logistics team has achieved success in:

- minimizing cost,
- minimizing liability,
- maximizing reverse velocity,
- improving profitability,
- improving asset recovery, and
- implementing innovative practices that maximize loyalty.

In reverse logistics, continuous, sustainable improvement is always necessary, and it requires rigorous processes, integrated systems, and a mature organization.