
PRIVATE BRANDS DIVISION

BUSINESS PROCESS REVIEW

MAY 1999

Distribution:

Private Brands
Management

Corporate Management

Table of Contents

	<u>Page</u>
Scope and Objectives	2
Executive Summary	3-4
Observations and Recommendations	5-15

Scope and Objectives

Internal Audit performed a business process review of the Private Brands Group (PBG) Buying / Sourcing functions. This is a strategic area of the business as Client is planning to double sales of private brand merchandise over the next three years. Private Brands sourcing was identified as a higher risk area in the 1999 Internal Audit plan, and this project was completed as part of that plan. The objectives of the business process review were to:

- Review, analyze and process map the functions ranging from production order through payment and delivery to Client Stores Logistics Network, excluding a field visit to the Hong Kong Buying Agent and validation of Customs Compliance (both of which are potential future audit projects)
- Identify risks and assess operational and financial controls over sourcing process
- Review adequacy of processes and controls
- Review processes for efficiency
- Develop recommendations to enhance controls and improve the process
- Benchmark Private Brands buying processes against best practices

The scope of the review covered the following areas:

- ❖ Production Order
- ❖ Shipping and Receiving
- ❖ Sourcing agent, as it relates to Fairfield operations
- ❖ Sourcing factory, as it relates to Fairfield operations

The Internal Audit team consisted of Stev, Jim, and Paul of Arthur Andersen, and Kyle of Client. We wish to thank the associates of the Private Brands division for their courtesies and cooperation. We would be pleased to discuss our recommendations in greater detail or otherwise assist in their implementation. The remainder of this report summarizes our detailed observations, recommendations and management responses.

Executive Summary

Effective on February 1, 1999, Client International and Product Development were consolidated to create the Private Brands Group (PBG). This change was made to enable growth, streamline operations, eliminate duplication of duties and reduce costs. Included in this consolidation is a change in operation of the sourcing function from a profit center to a cost center supporting the merchandising function. We understand the Growth Initiatives announced in the President memo will have an impact on PBG operations. The nature and extent of this impact has yet to be determined. As a result, implementation of a number of our recommendations is dependent upon the results of the Growth Initiatives.

While the changes have already yielded some of the expected benefits, full realization of benefits will not occur without addressing business and organizational issues, which lead to internal control concerns and opportunities for improvement in operating processes and efficiency. These issues are summarized as follows:

- ❖ The Private Brands sourcing organization was streamlined with the consolidation of Client International and Product Development. The consolidation did not include all functions, such as logistics and traffic, which are performed by multiple groups within Client. To further streamline operations and improve communication, we recommend that management evaluate the feasibility of consolidating the Private Brands Logistics/Traffic function into Client Stores Logistics Network.
- ❖ Client's goal is to grow the Private Brands business from 9% of retail sales in 1998 to 17% by the year 2000. The current business processes and information systems infrastructure do not provide the capacity or functionality needed to enable achievement of the goal. Investment in new or enhanced systems is required to improve controls, enhance communication, eliminate duplicative clerical tasks, minimize the need for manual intervention throughout the process, reduce cycle time in getting merchandise into the stores, eliminate non-value added work, and more accurately and efficiently track order status.

-
- ❖ Client can improve current operational efficiency and controls by enhancing systems functionality, performance and communication. For example, the same product information is entered separately into multiple systems and faxes along with emails are used to send data to the agent, Provider International LTD (Provider). These processes are not only inherently inefficient, but also result in information that is “out of sync” between the various systems and with Provider. These problems are intensified by the lack of consistent communication and inefficiencies which could be improved through use of complete and timely data and electronic data interchange (EDI) of purchase order information.
 - ❖ Infrastructure improvements are required in the area of formalization and standardization of communication, policies, procedures, performance measures and written agreements. The growth of the Private Brands business and the complexity of global sourcing necessitate formalizing certain business practices that in the past could be effectively controlled by one or a few people on a relatively unstructured basis.

We also benchmarked Client’s sourcing processes against information in an informal survey of national retailers and our proprietary database of Global Best PracticesSM KnowledgeSpaceSM. Specific areas where implementation of best practices could improve business performance have been included within our recommendations.

Observations and Recommendations

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

ORGANIZATIONAL

1. Effective 2/1/99 PBG re-organized, consolidating duplicate sourcing operations and improving efficiencies and communication. There are additional opportunities to further alleviate duplicate efforts and improve communications. For example, PBG Traffic may have order tracking information that is needed by other areas, but not systematically shared. As a result, each group is independently monitoring the status of shipments.

1. Evaluate the feasibility of combining the functional areas, CORPORATE LOGISTICS and PBG Traffic and Logistics, together in an organizational structure to create additional efficiencies, improved controls, reduced errors and better accountability. Best performing companies align their organizational structure with sourcing strategies and overall corporate strategies. Further, consideration should be given to implementing horizontal cross-functional teams vs. "silo" management with PBG, CORPORATE LOGISTICS and Buyers to align associates with CLIENT's overall goals.

1. Management agrees with this recommendation in principle. We will work with CORPORATE LOGISTICS on transferring the PBG Traffic functions to CORPORATE LOGISTICS. We will, however, keep the customs functions within PBG Logistics. The current Logistics personnel will perform the International Purchase Order (IPO) processes within the Product Managers area. This change will assure agreement between IPO's and Product Design Management (PDM) packages. These changes will be coordinated with the results of recommendations from the Growth Initiatives teams in 9/99.

INFRASTRUCTURE

1. The PBG systems are not flexible, efficient or state-of-the-art. As a result, the planned growth of the PBG area may be slowed or even halted. Several examples of systems opportunities are detailed later in this report.

1. Validation of the strategic direction for PBG will occur through the Growth Initiatives. Once the strategic direction is determined, we recommend that a systems evaluation be undertaken to assess requirements to meet long term objectives.

1. Management is in full agreement with this recommendation. We will discuss this matter with IT management by 6/99 and coordinate any plans with the announcement of recommendations from the Growth Initiatives teams.

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

2. There are only limited policy and procedural documentation for PBG.

2. Develop policy and procedural documentation in such critical areas as:

- expense approval,
- change management approval,
- standard product order data,
- claim processing, and
- external communications.

2. Management agrees with the need and will document policies and procedures by 8/99. We will then implement a training process for new hires and those accepting new responsibilities.

3. There are no specific performance measures for the operation, measurement and evaluation of PBG processes.

3. Establish formal quality, cost and time performance measures and evaluation criteria by which each PBG area is measured, such as:

Quality

- Returns to Vendor %
- Shipment Quality %.

Cost

- Merchandise processing & Distribution Expense as a % of Sales
- Transportation Cost

Time

- Cycle Time from Development to Order to Store Receipt
- Vendor Claims Turn-around

3. Management agrees with the need and will implement specific performance measures by 6/99.

4. CLIENT has long term relationships which have not been formalized as a written contract or agreement, including:

- Provider, sourcing agent

4. Formalize relationships with all third party providers as a vehicle to clarify roles and responsibilities. Such formalization will position Private Brands to meet strategic growth

4. Management agrees the relationships with our providers need to be formalized. We will discuss this matter with executive management and determine to what extent the

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

- Forwarder Intern'l., freight forwarder
- American Shipping, customs broker

Presently, CLIENT depends heavily on third party sources in PBG. This dependence is expected to increase with the growth and expansion planned for PBG.

PROCESSING

1. Processing purchase order data requires manual and duplicate efforts by PBG personnel and buyers. Parts of the product information are entered into four separate systems:
 - Product design and specifications,
 - International order management
 - Landed cost
 - Purchase order management

2. Better utilization of technology can significantly improve the operational

objectives, as well as, aid in resolving disputes regarding non-performance or legal issues.

1. As part of the systems planning, consider integrating and / or interfacing product design and specification, international order management, landed cost and purchase order management systems. This will allow a seamless flow of information, eliminate the duplicate manual entries, allow changes to be automatically reflected, decrease the potential for errors and ensure that the information is up to date.

2. Implement electronic data interchange (EDI) systems for

formalization should occur to minimize CLIENT's exposures with planned formalization by 9/99.

1. Product Development is proposing to replace the product design and specifications system to provide greater flexibility and accessibility of the product development data. Expected decision on implementation is 7/99 with expected implementation by 2/99. The system will allow for integration with the international order management system, by the expected date of 12/99. Management will review the integration needed in coordination with the Growth Initiative results.

2. Management agrees with this recommendation. We will

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

efficiencies of PBG and enable the planned growth. Hard copies of international purchase orders (IPO's) are sent overseas to initiate the orders with Provider. Hard copy order information is sent from Provider to Forwarder. Additional hardcopy data is sent to Arrow Marking for printing labels. Each of these transmittals can result in data entry errors, mechanical fax difficulties, etc.

3. In excess of 95% of the emails received by Client from external parties are for PBG. Reviewing these emails daily is critical to monitor the status of purchase orders and expedite shipments. Routing of incoming emails is a major effort. Recently the Company has experienced sending and receiving difficulties with emails resulting in the duplicate efforts of sending data by fax. These faxed data have caused additional operational difficulties through multiple copies and stages of data being handled.

4. The following are operational observations regarding product data

communicating with vendors. Use of EDI is a best practice and provides opportunities for the transfer of orders and change orders to Provider, and subsequently on to Forwarder, creating efficiencies and improving the accuracy of the order process. These efficiencies could reduce costs or the size of cost increases in the future.

3. Implement an email system that is more efficient, able to carry attachments and compatible with Provider and other users. (We understand this is an opportunity in other CLIENT areas.)

coordinate this system development with the announcement of recommendations from the Growth Initiatives teams in 9/99 and expected implementation by 2/99 after Year 2000 resources are available.

3. CLIENT is proposing to implement a new email system, which should significantly increase the efficiency of each email user and decrease the cost of handling emails. A final decision should be made by 6/99 with planned implementation by 9/99.

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

management (PDM) packages. These packages convey specifications within CLIENT and to third parties:

- a. PDM packages are sent to PBG Logistics prior to being finalized. After being finalized, PDM packages are often subject to change by the Product Managers and Buyers. These changes are not always effectively communicated through necessary channels, creating multiple versions, bottlenecks and delays in formal receipt of the merchandise, due to the differences. These changes are primarily due to price changes, market demand, changes in stores (openings, closings or remodelings) or extensions to cancellation dates. PBG associates have expressed concern with the volume of changes.
- b. Purchase orders for divisions 903, 966 and 909 must be "redefined", i.e., manually re-entered, by the accounting department because of special packing considerations.

5. During peak seasons, the use of

- a. Implement a version control of PDMs for each order. In addition, implement a change to order cutoff and a floor limit. These controls would be implemented after an order has been agreed between product design / specification (PDM) and purchase order management (POEM) systems. The cutoff could include locking changes out of the POEM system. Additional changes would require senior vice president approval.
- b. Eliminate redefining orders by utilizing standardized PDM packages.

5. Implement alternative staffing

- a. - b. Beginning in Spring '99, shipments will be classified as either allocated or non-allocated, requiring less changes, handling and sorting of merchandise. Full implementation of the recommendation includes systems issues. We will discuss these issues with IT management by 6/99 and coordinate changes with the results from the Growth Initiatives. Planned changes will begin after Year 2000 resources are available, about 2/99.
- b. A generic packaging policy is to be implemented with the Spring '99 season. This will eliminate the need for Accounting to "redefine" orders to achieve the customized packing.

5. Management agrees with the

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

temporary help for entering orders, etc., creates accountability issues and results in increased rejects and errors. The Product Managers have also raised concerns over the additional workload due to the added responsibility of sourcing, increased span of responsibilities and overall increase in private label business.

6. The international order management system's (ERSC) functionality is not fully utilized, for example:

- a. The ability to track orders in the ERSC system is limited. All the vital tracking information is not available on one report. Systems requests have been made for tracking reports including more thorough reporting, color tracking, etc.
- b. Cancelled orders are not adequately tracked to ensure that "problem" vendors are not used. For example, the ERSC system does not maintain cancellation data for both domestic and overseas sourcing of the same style. In addition, a Lotus spreadsheet is currently used, but all cancellations are not captured.

arrangements within the product teams during the peak seasons to allow for the most efficient means of handling the added workloads. The shared responsibility of entering orders would allow for cross training of the different departments.

- a. & b. Review the functionality of the ERSC system for additional benefits it may provide. There are potential changes to streamline the process and create efficiencies in PBG processes, including:
 - Use of date fields to provide better tracking.
 - Add transfer number and estimated time of arrival to Error Detail Report for a more thorough report.
 - Download cancellation data into Lotus from the ERSC system to assure cancellations are captured correctly.
- a. Expand access to the ERSC system's

recommendation and will develop a pool of clericals to shift between or increase staffing of product teams. We will coordinate this staffing matter with the results of recommendations from the Growth Initiatives teams.

- a. & b. Management agrees with this recommendation. We will coordinate this system development with the announcement of recommendations from the Growth Initiatives teams in 9/99 and expected implementation by 2/99 after Year 2000 resources are available. In addition, there are non-system changes throughout this report that will increase the flow of information between areas.
- a. Management agrees the system data should be available for additional users. This availability will require programming. As a result, we will discuss this with IT management to be addressed by 2/99 after Year 2000

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

information for users with the need.

resources are available.

7. There are also opportunities to enhance the functionality of the landed cost system:

a. PBG Traffic personnel take one half hour to enter each transfer. The system can handle the transfers, but this functionality is not being utilized. There are fifty transfers per week during peak times. In addition, there are certain "required fields" not being used for any reporting.

a. & b. Develop a list of cancellation codes to eliminate the myriad of reasons and to maximize use.

a. & b. Management agrees with standardizing cancellation codes. We will implement these codes by 6/99.

b. PBG Traffic, Logistics and Product Managers often want to view the history of transfers for comparing landed cost detail. The system only shows the latest transfer per style inquiry. The transfer history can not be researched by style.

a. Review the functionality of the landed cost system for benefits it could provide if fully utilized and eliminate "required" fields that are not being used.

a. - c. Management agrees with this recommendation. We will coordinate this system development with the results of the Growth Initiatives teams in 9/99, with expected implementation by 2/99, after Year 2000 resources are available. In addition, there are non-system changes in this report that will increase the flow of information between areas.

c. The bill of lading (BOL) number is currently required to maneuver within this system. The 14-digit

b. Modify the systems to enable inquiry on all past orders by style to significantly reduce the efforts for landed cost comparisons.

c. Obtain the ability to maneuver within the system by less digits of the BOL number, by the style or by the transfer number, and, the current full

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

BOL number makes entry difficult for PBG Traffic personnel.

BOL number.

COSTING AND ACCOUNTING

1. Open vendor claims with Provider for defective merchandise, late shipment credits, freight charges, etc. may not be adequately tracked to ensure that all claims have been resolved /or credit has been received. Differences with Provider's claims reports are not always timely researched.
2. Variations in landed cost are processed against purchases in cost of goods sold. It is possible a Buyer would not be aware of an actual landed cost difference. To-date there has been no reporting initiated which would allow PBG or Buyers to monitor actual to expected landed cost.
3. PBG accounting information can be utilized for better decision making

1. Maintain the support and an independent spreadsheet of all outstanding claims. This log should be reconciled with Provider's summary, so that all claims can be tracked and resolved in a timely manner. Formally approve all claims that are cancelled or reduced.
2. Establish formal reporting of landed cost variations, which would allow management to evaluate PBG's efforts to control costs.

1. Management agrees with the recommendation and will develop a Lotus spreadsheet to record the claims and will reconcile the report with Provider's summary. This spreadsheet will be implemented by 6/99.
2. Management agrees with this recommendation. We will coordinate this system development with the announcement of recommendations from the Growth Initiatives teams in 9/99 and expected implementation by 2/99 after Year 2000 resources are available.

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

with the following improvements:

- a. The reports put together by the Private Brand Analyst require two days of manual input of information into a Lotus format. Later, Brand Management reworks the same numbers at a different level of detail.
 - b. Product Managers and Buyers want reports and data to monitor the financial performance of private label goods at the SKU level.
4. PBG purchases its merchandise FOB factory, however, the accounting records do not reflect ownership until the Provider invoice has been paid.
 5. Goods are not financially accounted for on either PBG's or CORPORATE LOGISTICS's books at the transfer of goods from PBG to CORPORATE LOGISTICS.

- a. Consider merging the reporting efforts currently being done by the Private Brand Analyst and Brand Manager.
 - a. & b. Acquire the ability to download needed data into a Lotus spreadsheet to obtain more detail and to eliminate the manual input each month.
4. Any goods received FOB overseas should be accounted for on CLIENT's books.
 5. Goods in-transit between PBG and CORPORATE LOGISTICS should be accounted for on CORPORATE LOGISTICS's books.

- a. & b. Management agrees with this recommendation. We will coordinate this system development with the announcement of recommendations from the Growth Initiatives teams in 9/99 and expected implementation by 2/99 after Year 2000 resources are available.
4. The accounting of the inventory in transit will be discussed with accounting management by 6/99 with implementation no later than 2/99.
 5. The accounting of the inventory in transit will be discussed with accounting management by 6/99 with implementation no later than 2/99.

QUALITY ASSURANCE

Although our scope was limited to

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

Fairfield processes, we noted several operational issues within Quality Assurance (QA) that impact the effectiveness and efficiency of Fairfield processes:

- a. QA cancellation decisions may be re-evaluated so goods can be shipped without delay, sacrificing the quality of Private Brand's merchandise.
- b. QA has developed a formal set of policies and procedures for the factories. Included in these procedures is an acceptance agreement to be signed by the factories. This acknowledgement form is required of all factories. The form, however, may not be on file for each sourcing factory.
- c. The field inspector does not regularly visit all worldwide factories. There is currently one field inspector responsible for worldwide inspection. Although quality inspection is the responsibility of Provider and the factories, there were concerns expressed about communication of quality issues between Provider, factories and QA. Provider and factory inspectors may not be inspecting for the same quality

- a. Implement a formal management approval process, based on the product development team's consensus, when QA's decision is re-evaluated.
- b. Establish greater vendor accountability for QA issues. For example, violations of standards are automatically deducted from payments to Provider, if they are not a result of a CLIENT error. In addition, follow up should be conducted to ensure that CLIENT has a QA agreement for each sourcing factory.
- c. The field inspector should be in constant contact with the sourcing factories and with Provider, and should develop a physical presence in all the factories. A formal log of and summary reports should be kept for review, follow up and support. In addition, establish vendor performance criteria, which will hold all vendors to the standards required

- a. Management agrees with this recommendation and will develop a level of approval agreeable to all parties by 9/99.
- b. Management agrees with the changes recommended for claim procedures. We will implement these changes in 5/99.
- c. Management agrees with the intent of the recommendation. We will implement procedures for additional trips for new and problem factories and other factories in the immediate area by 6/99. In addition, management agrees with the recommendation and will implement the stronger stance with vendors by 5/99.

OBSERVATIONS	RECOMMENDATIONS	MANAGEMENT'S RESPONSE
--------------	-----------------	-----------------------

standards as QA.

by PBG. Implement procedures which utilize vendor performance criteria including cancellation data as an aid to the Product Managers and development teams for making subsequent sourcing decisions.