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PRODUCT RECALL:
REDUCING THE IMPACT OF PRODUCT RECALLS ON FINANCIAL STATEMENTS AND BRAND REPUTATION

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Executive Summary

From peanuts to eggs, pet food to auto parts and just about everything in between, thousands of products are recalled in the United States every year. Today, product recall campaigns occur more frequently and have become more costly than ever before. Brand and reputation management has never been more critical. To avoid potential disaster, organizations increasingly seek crisis management insurance products and services, such as product recall insurance, to provide a combination of traditional insurance indemnification with extensive consulting services both on a pre- and post-incident basis.

According to the popular adage, Murphy's Law, "If anything can go wrong, it probably will." When it comes to product recalls, a more educated consumer coupled with legislative changes regarding product safety, has seemingly increased the chances of this indeed being true.

Introduction

Even organizations with the best safety records and controls can, at times, after a product has been placed into the stream of commerce, find themselves dealing with a product recall situation. According to the popular adage, Murphy's Law, "If anything can go wrong, it probably will." When it comes to product recalls, a more educated consumer coupled with legislative changes regarding product safety, has seemingly increased the chances of this indeed being true. As a result, businesses with the "it will never happen to me" mindset, or those who simply neglect to prepare for the consequences of a product recall, are essentially playing Russian-roulette with the long term revenue prospects for their products, their brands, and even the industry. Just ask anyone in the U.S. peanut industry about the peanut recall of 2009.

Although they are on the rise, product recalls fortunately have not become high frequency occurrences for most businesses.

On March 23, 2009, the United States Food and Drug Administration (FDA) requested that nut distributor Westco Fruit and Nut Company voluntarily recall all products containing peanuts from Peanut Corporation of America (PCA).The recall was a response to possible health risks as a result of suspected salmonella contamination. Westco initially refused to comply with the recall request, leading the FDA to obtain an inspection warrant, which allowed them access to the company's records. The review resulted in sufficient evidence to issue a Class 1 recall of product distributed from PCA's Plainview Texas facility. The product from this facility was being shipped all over the world and used as an ingredient in thousands of different foods. Before the contamination could be contained it resulted in 714 confirmed infections, nine deaths and cost the U.S. peanut industry more than $1 billion. Subsequently, PCA filed for Chapter 7 bankruptcy and the CEO and owner were subpoenaed to appear before Congress. [1]

This example illustrates just how costly a product recall incident can be for an unprepared business. Factor in the expense to physically recall the product from distributors, retailers and consumers; the administrative costs; reputational damage; compensatory damages; and the costs of any product liability or other lawsuit relating to the goods; the costs can be staggering.

Although they are on the rise, product recalls fortunately have not become high frequency occurrences for most businesses. Similar to other low frequency but high severity exposures such as windstorm, fire and earthquake, they are insurable. As a result, organizations with both a pre- and post- incident product recall strategy, in combination with adequate insurance protection are usually in the best position if a recall were to occur.

Product Recalls

"A product recall is a legal term of art," explains Katherine Cahill, Founder and CEO of Cahill Consultants, Inc. "Companies are required to conduct product recalls when they have put a product into the stream of commerce that can or has already caused a safety related issue that was not anticipated when the product was originally designed or manufactured."

According to data compiled from the FDA, the Department of Agriculture (USDA), and the Consumer Product Safety Commission (CPSC), the number of product recalls is on the rise. In 2011 there were 2,363 recalls of consumer products, pharmaceuticals, medical devices and food in the United States. This represented a 14 percent increase from the prior year, and a 62 percent increase from 2007.

A voluntary recall occurs when the company decides to pull the product from the stream of commerce because of a safety issue. By law, businesses are legally required to do this or risk paying fines or having their operations shut down entirely.

Many are questioning why there has been this sudden spike in product recalls? Are the products today less safe than in the past? According to experts, it is not that products are made any less safe, but rather more are being recalled as a result of various factors, including better testing procedures, and the use of social media where consumers can openly discuss problems as well as greater oversight by regulators.[2]

The spike in the number of recalls has created a growing concern that consumers are experiencing so-called product recall “fatigue.” As a result, some retailers and government agencies are exploring different methods of how to communicate with the public and get their message out about a particular product, such as through social media. Others simply believe the message needs to be more consistent and are calling for a more uniform recall system between regulators such as the CPSC, USDA and FDA.[3] Responsible organizations must first observe the recall request and protocol of the regulatory body, but then determine for themselves what else they can do to protect their customers.

Voluntary vs. Involuntary Recalls

Recalls of unsafe products are conducted on either a voluntary or involuntary basis. Increased regulatory oversight, which will be discussed in greater detail later, might lead some to believe that the majority of product recalls are involuntary. In fact, the contrary is true. However, Cahill notes that, although a company may take the initiative in instigating a recall, to say it is “voluntary” can be misleading. “The reality is that despite how the recall is labeled, few are truly conducted on a voluntary basis,” she said. “A voluntary recall occurs when the company decides to pull the product from the stream of commerce because of a safety issue. By law, businesses are legally required to do this or risk paying fines or having their operations shut down entirely. Anything with this much regulatory oversight is not done on a voluntary basis.”

Conversely, an involuntary recall occurs when a company refuses to take their product out of the stream of commerce. The incident discussed at the beginning of this paper involving Westco Fruit and Nut Company provides a real life example of this. When this occurs, government regulators will essentially force the company to conduct a recall. Cahill explains, “In both cases, the government oversight is what drives the decision”.

Aside from the obvious cost associated with removing the product from the stream of commerce, and potential legal expenses, a large recall may result in bad press that can significantly tarnish a business's reputation or brand.

Types of Recalls

Regardless of the method by which the product is recalled, it is required to be removed from the stream of commerce because it presents a public safety concern. However, not all product recalls pose the same threat. For this reason product recalls are given a classification to alert the consumer as to the seriousness associated with the product's safety.

Class I recall: This is the type of recall that usually garners the most media attention. Class I refers to a recall where there is a reasonable probability that the use of or exposure to a product will cause serious adverse health consequences or even death. (E.g., E-coli contamination)

Class II recall: Class II refers to a recall by which the use of or exposure to a product may cause temporary or medically reversible adverse health consequences or where the probability of serious adverse health consequences is remote. (E.g., Bacterial infiltration of Staphylococcus adequate to cause food poisoning.)

Class III recall: This designates a situation when use of or exposure to a product is not likely to cause adverse health consequences. (E.g., A contamination related to aesthetic qualities such as off taste or color; and/or labeling violations.)

An example of a Class I recall that may still be fresh in the memories of many is the recall of shell eggs in August of 2010. The recall occurred after health officials in California, Colorado and Minnesota, investigated several restaurants where multiple people fell ill with Salmonella Enteriditis. As a result of the investigation, health officials agreed that shell eggs were the likely source of the infections. Consequently, Wright County Egg of Galt, Iowa, conducted a nationwide voluntary Class I recall of eggs that shipped between May 19, 2010 and August 13, 2010. In all, more than 500 million eggs packaged by several different brands were recalled nationwide.[4]

As previously mentioned, depending on the product and the scope of distribution, Class I recalls, such as the recall of eggs just discussed, can be devastating to both the company's balance sheet and its reputation. Aside from the obvious cost associated with removing the product from the stream of commerce, and potential legal expenses, a large recall may result in bad press that can significantly tarnish a business's reputation or brand.

The purpose of the FSMA is to ensure the U.S. food supply is safe by shifting the focus of federal regulators from being reactive to proactive.

Legislative Changes

Product safety and regulatory compliance are issues that should concern just about every corporate executive whose company has a product recall exposure. Failure to pay close attention to these issues can result in a tarnished brand, fines and penalties, and even criminal prosecution. Two relatively new pieces of U.S. legislative with product recall implications include The FDA Food Safety Modernization Act (FSMA) and The CPSC Consumer Product Safety Improvement Act (CPSIA).

The FDA Food Safety Modernization Act (FSMA)

The purpose of the FSMA is to ensure the U.S. food supply is safe by shifting the focus of federal regulators from being reactive to proactive. According to FDA Commissioner Margaret A. Hamburg, M.D, the reason for this shift is because "the burden of foodborne illness is considerable. Every year, 1 out of 6 people in the United States – 48 million people – suffer from foodborne illness, more than one hundred thousand are hospitalized, and thousands die," [5]

Signed into law by President Obama on January 4, 2011, the FSMA increased the recall authority of the FDA. Some important legislative changes include: [6]

- ***Mandatory Recall Authority:*** The FDA will have mandatory recall authority for all food products. Although the food industry is largely compliant with FDA requests for voluntary recalls, according to the FDA, this new authority is a critical improvement in in their ability to protect the public health.
- ***Formal Written Protocols for Recalls:*** The legislation requires food facilities to proactively evaluate the hazards in their operations, implement and monitor effective measures to prevent contamination, and have a plan in place to take any corrective actions that are necessary.
- ***Long Arm Statutes for Reaching Food Facilities Outside of the United States:*** The legislation enhances the FDA's ability to oversee food products being imported from other countries each year.
- ***Inspection and Compliance:*** The legislation understands the inspections are essential in holding the industry accountable for producing safe products.

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The Consumer Product Safety Improvement Act (CPSIA)

The CPSIA came into effect in August 2008, and authorized a variety of new regulations and testing requirements for the production of children's products, as well as some non-children's products. Manufacturers, importers, distributors and retailers of consumer goods must ensure that their products comply with the CPSIA. Some key points of the legislation include:[7]

- Lead content and lead in paint and similar surface coating restrictions;
- Phthalate restrictions: Phthalates are chemical plasticizers that are often used in the production of many types of plastics, certain inks and other products;
- Reasonable testing programs to assure products comply with safety laws;
- Independent third party testing labs on children's products; and
- Labeling requirements: Date and place of manufacture are now required on labeling of children's products.

The Impact on Financial Statements and Brand Reputations

A product recall, whether voluntary or involuntary, can have long-term effects on the revenue prospects for a product and ultimately for the business as a whole. According to an analysis conducted by a leading accounting/consulting firm, a significant decline in future sales as a result of a product recall could have a huge impact on a business's calculated fair value.[8] Some of the factors that can negatively impact future cash flow include:[9]

- A reduction in forecasted revenue due to lost product confidence,
- The amount of time needed to regain market share,
- Whether or not market share should be expected to reach the same levels as before the recall,
- A change in the timing of cash flow activity,
- Increased marketing expenses necessary to regain market positioning, and
- Analysts forecasts for future product sales and past performance benchmarks

The overall impact of a product recall on a business's balance sheet also often coincides with the impact that it has on its brand. It typically takes years for a business to develop its brand reputation, one of its most valuable assets, but it can take only moments for that reputation to be tarnished. In the digital world, and a world of 24-hour news cycles, information is disseminated globally nearly instantaneously. If not handled correctly, product recalls can do serious damage to a brand. If handled well, however, a company may even emerge from a recall situation with an enhanced reputation as well as a strong brand. The textbook case is Johnson & Johnson, which was praised for its socially responsible actions when, in 1982, the company acted quickly to take its most profitable product, Tylenol, entirely off the market after several people died from capsules laced with cyanide.

Preparing for a Product Recall

For businesses involved with the production and/or distribution of goods, the "it will never happen to me" mindset regarding a recall of one of its products is not only shortsighted, but also potentially damaging to its customers, distributors and suppliers. Product recalls happen, and when they do, the best way to minimize the impact is through planning and preparation.

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In addition to staying on top of legal and regulatory changes, developing a product recall plan is essential. Vital procedural components that should be included as part of any product recall plan include:[10]

- **Written procedures for identifying and dealing with a safety issue:** Identifying a potential problem early and addressing it quickly can help keep a product recall situation from spiraling into a crisis. Procedures should address customer complaints, returns, warranties and product safety testing.
- **A product recall chain of command:** A product recall task force should be identified in advance, and detailed roles and responsibilities should be assigned. Contact information should be collected for all team members since recalls do not only occur during business hours.
- **A communication plan.** Effective communication with the news media, regulatory officials, investors and other stakeholders is vital. A company spokesperson should be designated in advance and should receive training in dealing with the media. In most cases a PR firm should be retained to help craft the most effective message. The communication plan also should include a social media strategy.

Even the most detailed and comprehensive product recall procedures may be of no use if team members are not properly trained on them. Periodic training, such as mock product recalls are recommended to remain fresh and prepared to respond in a real life situation.

While the costs associated with recalling the product from the stream of commerce can be reduced with planning and preparation, they will still likely be significant. According to a 2006 Washington State University study, it was estimated the average cost of a product recall

Product recall insurance provides the insured indemnification for their financial loss resulting from the recall of a product (e.g. recall costs, loss of profit, replacement costs etc.).

is $540,000, more than double that of an average product litigation settlement ($217,000), and costs can run into the hundreds of millions of dollars.11 For this reason insurance should be considered.

Product Recall Insurance

According to Florian Beerli, SVP Product Recall Underwriting, ACE Westchester, "The basic philosophy behind Crisis Management Products (which includes product recall), is to offer traditional insurance indemnification as well as extensive consulting services both on a pre- and post-incident basis."

Beerli explains, "It is not liability coverage, but it goes hand in hand with it. They both look at products and the exposure of it, but whereas products liability is paying for third-party damages (bodily injury/property damage), product recall is a first-party coverage protecting the insured's balance sheet and brand name."

Product recall insurance provides the insured indemnification for their financial loss resulting from the recall of a product (e.g. recall costs, loss of profit, replacement costs etc.). Coverage also includes an option for third-party costs (e.g. customer loss of gross profit, customer extra expense etc.), but the insurer typically does not remit payment to the third-party but instead reimburses the insured for losses sustained.

Beerli explains, "It is catastrophic event coverage, such as wind and earthquake, with low frequency but a high severity. A company does not normally have a recall every year but when they do it is time consuming, costly and can be damaging to the business."

Conclusion

In the United States, an increasingly educated consumer has resulted in more comprehensive product safety legislation and more products being pulled from the stream of commerce. While still not a frequent occurrence, the chances of this happening are much higher than in the past. As a result, businesses should prepare for how best to respond to help minimize the impact a recall can have on both its financial statements and its reputation. Fortunately, businesses do not have to do it alone; instead they can seek guidance from insurance carriers who specialize in product recall coverage that will not only provide financial statement protection via insurance indemnification but also reputation protection through consulting services provided on both a pre-and post-incident basis. ■

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