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Cost to serve:
Does your profitability reporting tell the full story?

"What gets measured gets improved."

Peter F. Drucker

To stay competitive in the marketplace, companies are leveraging both operating and financial data to generate business insights and improve profitability measures, focusing on strategic questions, such as:

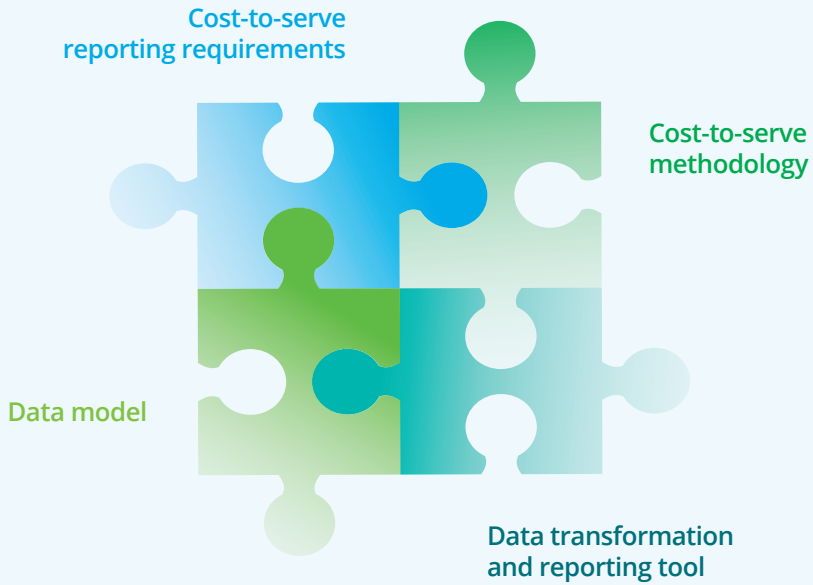
- Where is our business thriving or struggling, and why?
- Are we focused on the right costs and levers to manage profit margins?
- Are we able to obtain "data-driven" performance information efficiently?
- Do we know the total cost to serve each of our customers?

If business leaders are unsure of the answers to the questions at left, their organization may be experiencing gaps with either data availability or in leveraging their data for management decision-making. The cost-to-serve reporting approach can help provide confidence that profitability reporting is complete and providing accurate insights into key aspects of financial performance.

What is cost to serve?

As a rule of thumb, when discussing profitability, most companies will point to gross margin (by either product or product group) as a main profitability indicator. Although this measure is widely used by companies and may be considered a comparable metric to gauge profitability, there may be a lack of visibility into the cost components included or excluded from the calculation. These cost components can vary significantly from company to company within an industry, together with the basis for any cost allocations included in the calculation of gross margin. This is where cost-to-serve reporting brings value to operating performance analytics.

Cost to serve (CTS) is the analysis and quantification of activities and related costs incurred through the end-to-end value chain to deliver a product or service to a customer. It provides reporting transparency into the actual costs of delivering products or services to customers across different dimensions, such as products, customers, channels, and/or regions. Cost to serve reporting involves identifying key strategic CTS reporting requirements, an assessment of data availability, a consistent methodology to define CTS reporting organization-wide and a reporting tool to generate the analysis.



Quantifying CTS can improve decision-making, including determining future service levels, activating supply chain strategies, negotiating commercial terms, and assessing customer pricing.

Key data considerations to enable a CTS model

A cost-to-serve model requires a **blend of financial, operational, and transactional data** to provide a comprehensive view of the costs required to deliver products and services to customers.

Leveraging different data types to build a CTS model should include the following considerations:

Master data design. Company master data design should support the granularity desired for calculating and reporting Cost to Serve. Data dimensions can include product-level freight rates by region, warehousing costs, quality, overhead allocations and more, depending on the nature of costs incurred to support delivery to the customer.

Quality, completeness, and granularity. The level of data granularity and its availability consistently across manufacturing sites and regions can significantly impact your CTS model. More detailed data can provide more precise CTS analysis but may be more challenging to collect and manage.

When building a cost-to-serve model, consider the granularity and availability of your data to prepare end-to-end cost reporting.

Key types of data that you will need

1. **Financial data:** This includes direct and indirect costs incurred to manufacture products or serve customers, together with a view of fixed versus variable costs.

2. **Operational data:** Provides insights into the efficiency and effectiveness of your operations. This may include:

   - Order quantities
   - Inventory/storage costs
   - Freight/delivery costs
   - Production cost data
   - Cost of working capital metrics
   - Return processing costs

3. **Transactional data:** Detailed data by transaction, such as order size, order frequency, and the cost of each order. This data can help identify patterns and trends in customer behavior.

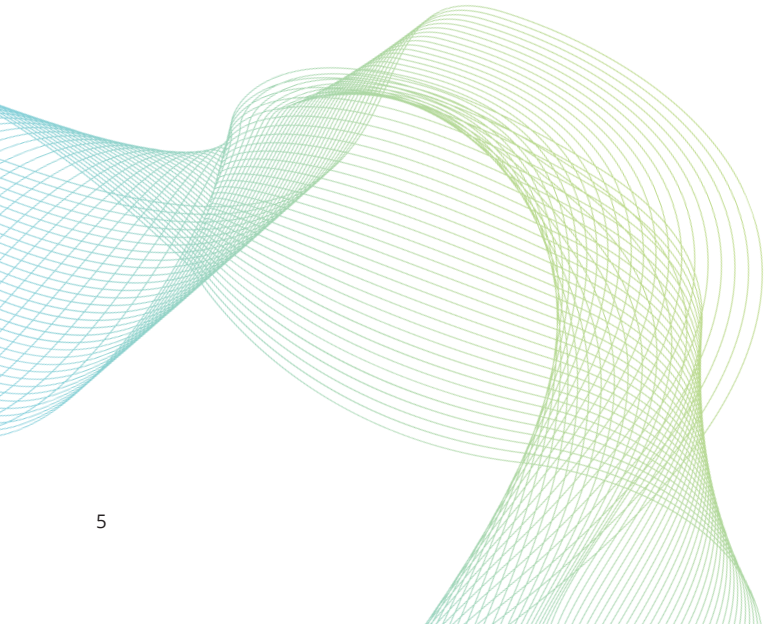
4. **Customer data:** This includes information on customer locations and segmentation, which can help identify those customers that are more expensive to serve.

5. **Product data:** Data on the cost, price, details of product (unique specifications), and demand for each product can help identify which products/services are more expensive to manufacture and deliver.

6. **Channel data:** Information on the costs associated with each distribution channel can help identify which channels are more costly to serve.

Implementing cost to serve with a data aggregation and calculation engine

Today, organizations have large datasets available that can be leveraged to build robust cost-to-serve models. Current tools in the marketplace are capable of consuming these large datasets from multiple source systems and performing complex calculations at high processing speeds, often down to the product or service level. The reporting from these tools enables detailed analytics and scenario analyses with increased cost transparency across the value chain to support pricing and spend decisions.



Core ERP
Logistics
Sales orders
Production
Other systems

Multiple sources
Multiple data sources are leveraged, in addition to the information available from an organization's core ERP.

Cost to serve model*
Data aggregation, calculation engine and modeling tool that enables analysis down to the product or service level, where previously this may not have been practical when using other analytical tools

Reporting
Deliver cost-to-serve reporting and analysis to provide insights into customer, product and/or regional profitability in support of strategic decision-making.

In addition to generating detailed cost-to-serve analyses, these tools enable the preparation of cost simulation scenarios to evaluate the impact of different cost-to-serve options to deliver value to customers.

* Calculation engines enable companies to perform complex calculations, such as allocation calculations, using large data volumes at high processing speeds. The granularity and accuracy of the allocations implemented will then translate into robust cost-to-serve analyses.

Benefits of cost to serve

Truly informed decision-making requires understanding the enterprise-wide cost of resources to deliver by customer, product, and/or service. Without this cost transparency, management may not understand the full impact of its business decisions. Key advantages of CTS reporting include:

Cross-functional value chain perspective
A "horizontal" cross-functional value chain perspective of the total cost to deliver products or services, beyond product costs or direct service costs.

Dynamic forecasting
Enables advanced dynamic analytics that provide descriptive and predictive insights for decision-making.

Collaborative decision-making
Facilitates a collaborative cross-functional decision-making process and business alignment that leverages fact-based data.

More strategic pricing
Ability to price products and services in alignment with a company's long-term vision by increasing visibility into the markets/customer groups and realize additional value.

Case studies

Global consumer products retailer and distributor

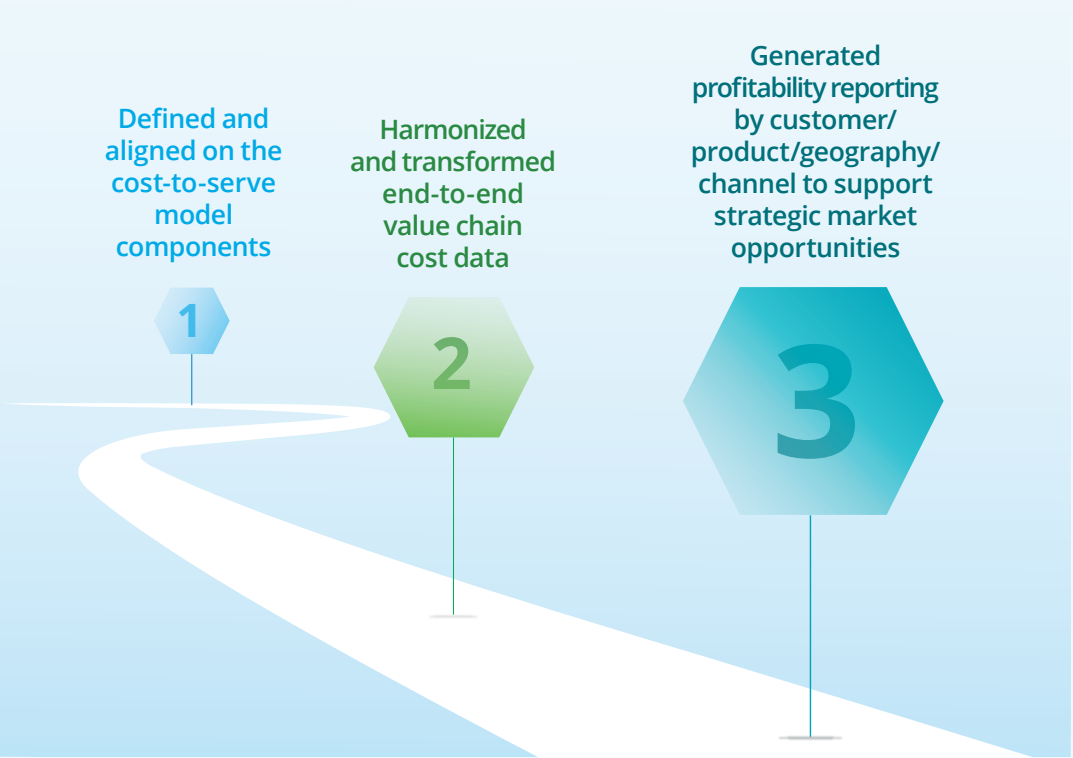
Situation:

A global sports apparel manufacturer was transforming its business strategy to improve direct-to-consumer sales profitability.

Challenges:

- Limited understanding of current product cost components and breakdown of CTS by customer segments (customer, geography, channel, etc.)
- Current reporting systems did not accurately track product costs and provide insights into cost fluctuations period over period
- Lack of visibility into total costs to manufacture and deliver products across the value chain

Solution:



Development of a Cost to Serve model allowed the company to perform a deep dive into costing/service mode by mapping ~US$1B of spend against ~10,000 customer accounts, and corresponding product sales, ultimately leading to **$15M of potential margin improvement opportunities**

Case studies (cont'd)

Global shipping and logistics provider

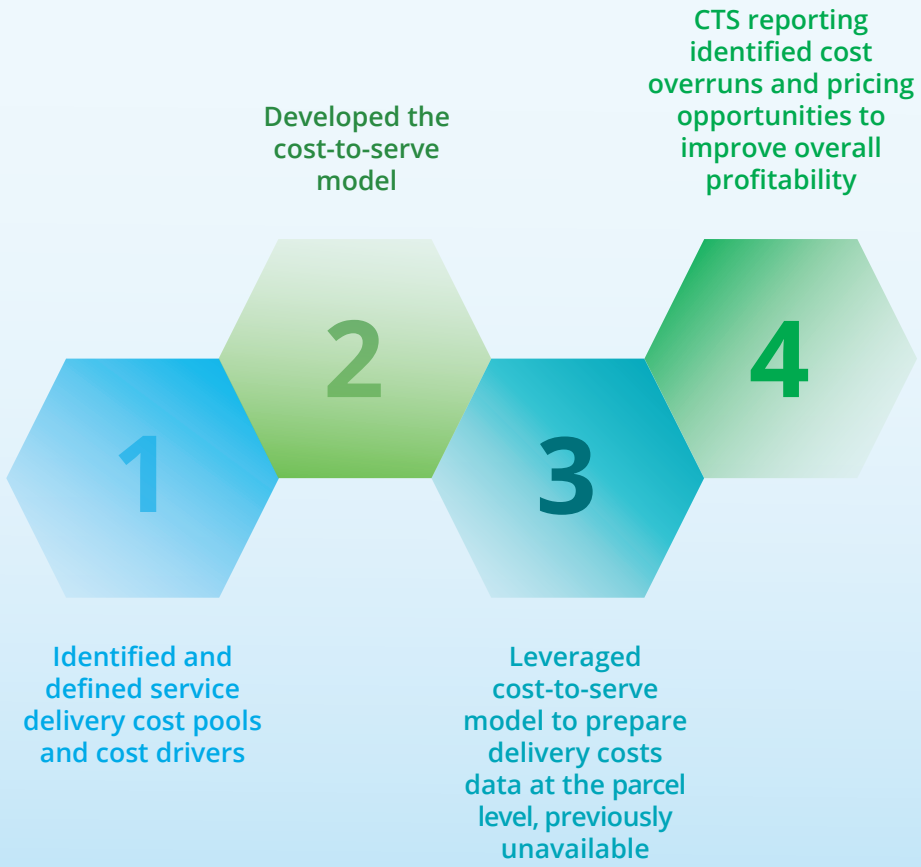
Situation:

A global consumer products shipping company lacked insights into its customer-level profitability to evaluate pricing and overall business performance. An influx of volume was not leading to improved margins.

Challenges:

- Relied on complex manual spreadsheet models to formulate service cost profiles by customers and parcels using static cost assumptions
- Minimal transparency into the actual cost of serving customers across different regions and parcel types

Solution:



The company discovered its pricing did not cover the total cost to serve key customers, adversely affecting profitability. As a result, the company took a critical look at customer pricing, incorporating total cost to serve customer data, to negotiate new terms and improve overall business performance.

Conclusion

As companies gather more and more financial and operational data through their ERP and operating systems, finance and business professionals are now able to leverage this information to develop cost-to-serve models to gain more insights into profitability and business performance.

We have seen benefits of using cost-to-serve models to better understand the total cost to deliver products and services to customers, enable more accurate pricing decisions, and provide more visibility to the cost levers affecting business profitability.

Cost-to-serve models and tools provide cost transparency for collaborative cross-functional discussions on business strategy and the impacts on operational performance.

In an environment of increasing competition and need for data-driven insights, CTS models empower management with the information required to understand the impact of key decisions on operating performance and evaluate marketplace opportunities.

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