White Paper

Better Margin Management With Cost-to-Serve

▸ *In Consumer Packaged Goods Organizations*

Business Objects™

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Audience: CFOs, financial managers, marketing managers, and sales managers in consumer packaged goods organizations.

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Executive Summary

Management of costs and pricing is fast becoming a key competitive weapon in consumer packaged goods (CPG) markets, where sales volume growth is low, product differentiation is difficult or costly, and where buying power resides in the hands of a few powerful retailers. An organization's ability to improve its financial performance in these circumstances often resides in the ability to reduce costs and improve profit margins. However, this may only really be possible if an organization has a true and accurate insight into the costs and profitability of the business. In many instances, consumer goods organizations fail to gain the true insight they need: On the one hand, they use the wrong metrics to monitor and manage pricing in the business; on the other hand, their analysis of margins is incomplete. They often fail to account for the cost-to-serve element of any individual transaction.

Cost-to-serve analysis offers a practical solution to an organization's need to monitor and manage costs, pricing, and true profitability. By using well-established activity-based costing (ABC) techniques, delivered through advanced web-based software technology, organizations have the ability to gain insight into the costs that drive their businesses and analyze the effect on overall profitability. The result can lead to significant improvements in pricing strategy, customer management, product management, and price negotiations—all of which could lead to improvements in the bottom line.

This paper examines the impact that cost-to-serve analysis can have on an organization's ability to manage costs and profitability, and discusses the role of ABC techniques and the possible benefits that could result.

Introduction

Competing in CPG is already difficult enough and is unlikely to get easier. In developed economies, many product categories in the food sector have been mature for a number of years, with little or no growth. At the same time, prices have been decreasing. Maintaining a brand that has consumer pull-through has also become more difficult—and more costly—as traditional advertising media continues to fragment, and audiences have the technology to fast-forward through advertising breaks, for example.

The key issue is the relentless shift of power towards the retailer, so now most manufacturers make the vast majority of their sales through a handful of dominant retailers. Once there was the independent sector of small corner shops served by wholesalers, which—despite being a small part of most markets—always offered the prospect of better margins. Today, this sector is under pressure from the same large retailers who dominate the hypermarket and supermarket space as they extend their fascias into high street and local formats.

Developing new products and entering new markets have always been the traditional ways of seeking new growth opportunities, but these too are becoming increasingly difficult. The cost of developing new products, and even new variants of existing products, is high—and few recoup the investment. Likewise, expansion into new territories, such as Eastern Europe and Asia, fails to provide a panacea. In many countries, including China, the same global retailers dominate the local market. There's simply nowhere for food manufacturers to go to avoid the major players.

All of these challenges—the shift in advertising approaches, brand management, growth opportunities, and retailer domination—are making the consumer goods market a tough environment. Whereas once investing in the brand was the route to profitability in consumer goods, today execution is equally important. That means really coming to grips with the two things that drive margin—cost and price. Every piece of business transacted with the large multiples must always contribute to the bottom line. Cost management has always been a priority for management accountants, and will be returned to later in this paper. But pricing typically has been a shared responsibility for people in commercial roles, where the conflicting priorities of achieving sales targets and growth in market share may not always lead to good pricing decisions.

Pricing for Profit

Pricing is too important for any one department to own. Because of the impact price improvements have on profitability, pricing needs to be a top-line concern for senior management and boards of directors. Research[1] has shown that for the average company, a 1% improvement in pricing, with no loss of sales volume, creates an 11% increase in operating profit—far in excess of that achieved by either a 1% improvement in fixed cost, variable cost, or sales volume. Figure 1 below shows these comparisons.

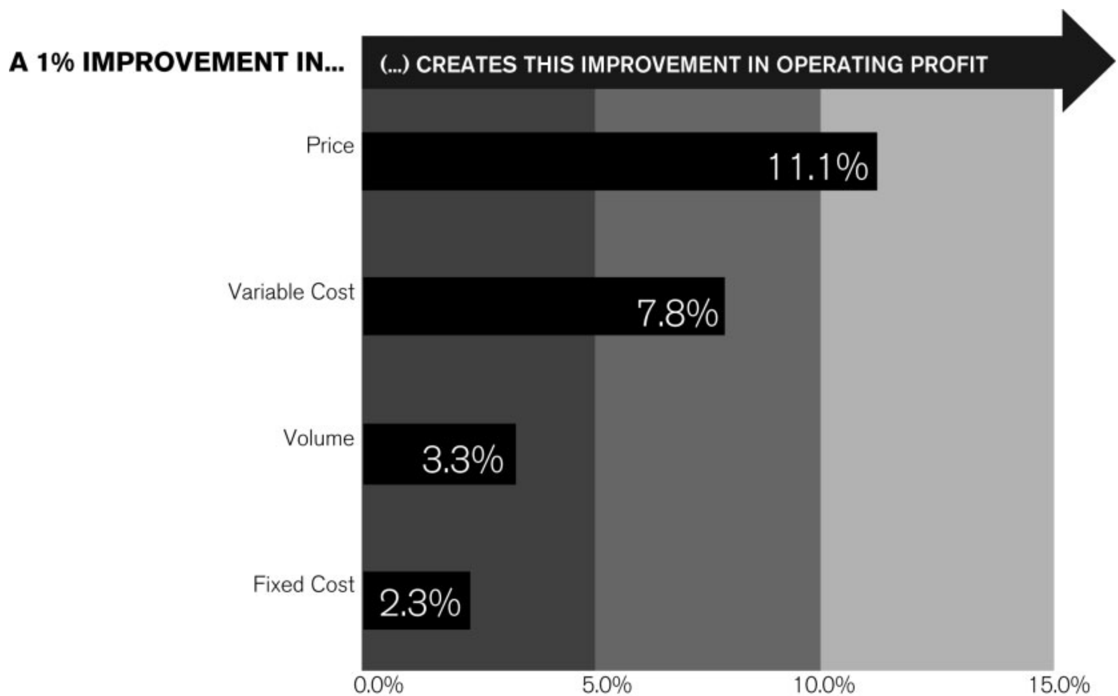

Figure 1. Comparative impact of improvements.

[1] Quoted in "Managing Price, Gaining Profit", Michael V Marn and Robert L Rosiello, Harvard Business Review, Sept-Oct 1992, pp84-93

As improvements in price have nearly four times the impact of improvements in volume, the fastest and most effective way for many companies to optimize profitability is to get their pricing strategy right—a concept that has been proven time and time again in all sectors of business. Marn and Rosiello[1] refer to a consumer-durable company that improved operating profits by nearly 30%, with a mere 2.5% increase in average selling prices. At a time when growth in volumes is difficult to achieve, pricing is a potent weapon.

However, for many providers of consumer goods, it's also a double-edged sword. This powerful leverage works backwards as well as forwards, and a 1% reduction in average selling prices will slash operating profits by 11%. Every time buyers ask for that little bit more, they're driving a sword deep into their supplier's financial well-being. Either you prepare for these types of negotiations with full knowledge of the exact point when an individual order becomes unprofitable, or you have to rely on accepted wisdom or intuition. Eventually, these options may no longer hold true.

As many consumer goods manufacturers rely on a handful of key accounts for a major part of their sales, they're equally loath to push prices too far and risk delisting—something that would devastate market share at a stroke. You have only to trace the fortunes of any major provider of milk, most of which is pure commodity and supplied under retailers' own labels, to see the importance that pricing, distribution contracts, and the perpetual pursuit of volume have on maintaining an adequate level of profitability. Small improvements in price can quickly transform the bottom line.

Issues in Pricing Practice

But while pricing is undoubtedly complex and connected to many other business issues—such as product positioning and capacity utilization—many would argue that even some of the top performers in their respective markets let themselves down when it comes to the detailed management of pricing and discounting of individual transactions. Global analyst group AMR Research suggests that fewer than 3% of companies manage, communicate, and enforce prices[2]—and this is despite the suggestion that the benefits of improving pricing are virtually unparalleled. AMR and other authorities suggest that one of the main weaknesses in pricing execution is the lack of focus on the real "net net" profitability of individual transactions. In a complex, multiproduct business—with numerous dealer promotions, marketing allowances, and retrospective annual rebates—the real price that buyers actually pay (the so-called "pocket price") can be far below the invoice price captured in transaction systems. Figure 2 shows an example of such a price waterfall, first described by Marn and Rosiello.

[2] "Price Management, Conventional Wisdom is Wrong", AMR Research Outlook, February 2004

On the surface, the discrepancy between invoice price and pocket price may suggest lax sales management, but this misses the point. Discounting and price-led promotions are a fact of life—especially in those categories where products have a limited shelf life and can quickly become worthless. It's therefore not surprising that suppliers have to be flexible and react quickly to move excess or short-dated produce through the supply chain. In these situations, list prices are simply the starting point for prices, with ongoing and ad hoc sales and marketing activities focusing on promotions, discounts, rebates, and a plethora of other ways to encourage buyers. The real issue is that many companies don't have the information they need to manage pricing and discounting at the necessary level of detail.

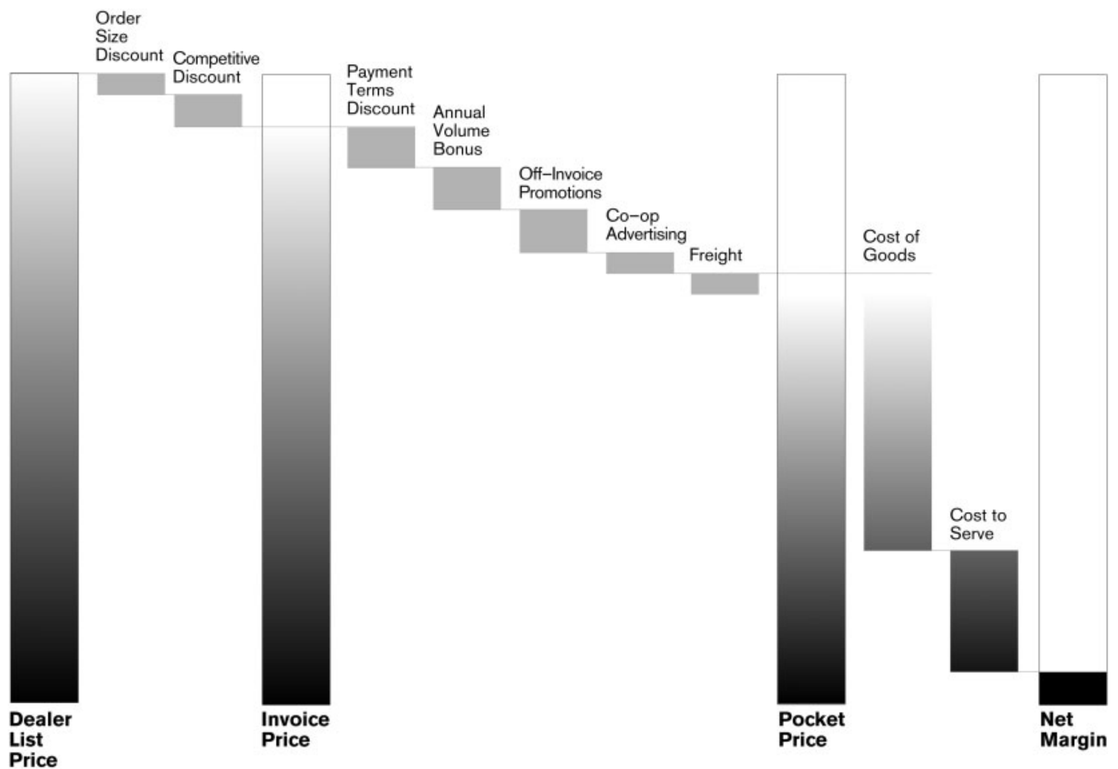

Figure 2. An example of the pocket price waterfall.

Problems With Existing Pricing Solutions

Software is available that allows companies to manage pricing, allowing users to analyze and test pricing sensitivity and to systematically enforce pricing and discounting policies. While such applications undoubtedly help, they only address the process-side of pricing management. The critical issue here is that the wrong metrics are being used to report pricing. As has been suggested above, invoice price rather than pocket price is the main measure being used to measure performance. Working at the level of gross margin is a poor substitute for more detailed analysis—and may result in misguided decisions that erode profitability.

The objective of transaction price management is to gain the best possible net realized price for each order. A system that tracks the true net price by transaction is essential when setting and enforcing pricing policy. This is achieved by reallocating off-invoice discounts, rebate terms, and other allowances back to the individual transactions, based on equitable drivers that reflect the realistic burden for each transaction to carry. In practice, such allocation procedures across large volumes of transactions require fit-for-purpose applications to manage the calculation complexities in an efficient and timely manner.

Armed with this information, management can assist field sales and sales managers by setting appropriate parameters for discounts and terms for different customers or categories of customers, products, and stock keeping units (SKUs). Benchmarking the pocket price average and range (for a given volume) by product, by customer, by sales region, and even salesperson, also highlights areas for attention. What's more, by regularly updating the system—typically weekly in the fast-moving consumer goods sector, and monthly in others—managers can analyze the variance between target and actual pocket price to track progress on accounts.

However, there's a second, more fundamental issue—and this is that the current level of margin analysis is inadequate for informed decision-making. Although reporting pocket price will provide visibility of real "net net" prices, it doesn't provide insight into true end-to-end profitability across the entire lifecycle of each transaction. This is where the concept of cost-to-serve plays a critical role.

Identifying Cost-to-Serve

Customers, products, and distribution channels consume different levels of resources from shared business functions—such as sales and marketing, credit control, warehousing, and logistics, as well as support functions such as IT. These functions are the individual elements that make up the cost-to-serve for a particular customer, product, or service. If pricing and profitability analysis stops with the calculation of contribution (i.e., pocket price minus cost of goods), it fails to reflect the cost-to-serve. The only way to understand cost-to-serve and report on true end-to-end profitability is by implementing activity-based costing (ABC).

The Role of Activity-Based Costing

Having survived the hype of the last two decades and proven its value many times over, ABC is back on the corporate agenda in a number of sectors where the level of adoption has been low. After the initial burst of enthusiasm it enjoyed in the early 1990s, ABC came to be viewed as too time-consuming and laborious to be worth implementing. Collecting data that's not stored in any software system—such as the proportion of time a department's staff spends on various activities—used to be particularly tedious, so that models were recalculated infrequently and reports were quickly out of date and ignored by line managers. The ABC movement lost momentum as this negative perception spread. But after organizations invested millions in new transaction systems and data warehouses—only to find they still didn't know which customers and products were profitable or how much business processes cost—ABC began to climb the corporate agenda again and is now being adopted as one of the core elements of corporate performance management (CPM). The old guard, which has stood by ABC for decades, seems to have been proven right.

Companies that have incorporated ABC well have realized benefits that make the initiative worthwhile. Research by David Southiere, an associate partner with global consultant company Accenture, suggests that an ABC project's identification of opportunities to remove non value-adding activities can lead to step changes in the cost base of between 3% and 5%. His research also shows that ABC's ability to focus organizations on margin management and on growing profitable areas of business can lead to revenue growth in the range of 5% to 15%.[3]

[3] Accenture, CFO Project Vol.2, October 2003

Today's approach to ABC projects tends to be more pragmatic than in the past, when overzealous management accountants and their retained consultants mindlessly followed textbook methodology and systematically decomposed the general ledger through hundreds and sometimes thousands of increasingly insignificant activities. Little wonder ABC got a bad name! Today's initiatives focus on providing business managers with the right type of information to help them make better decisions. Typically, this means focusing on a smaller number of higher-level activities and providing more frequent reports, so that the costs and profitability of items such as products and customers can be tracked over time. The advent of web-based applications that eliminate much of the tedium and cost involved in collecting and collating non-system data has made it easier. These newer applications allow users to refresh data in their models more frequently, and they enable managers to access reports from their desktop, then drill down into the data to better understand costs and profitability in their particular area of responsibility. Gone are the days of having to tailor endless reports for every department.

Principles of ABC

ABC is based on a few basic principles, which are really just common sense.

Principle 1: Activities consume resources.

The more an activity is performed, the more resources will be consumed by it.

Principle 2: Activities have a cause.

All activities are performed for a reason or cause. In the most efficient organizations, activities are mainly attributable to external objects—customers, products, or distribution channels. Usually, though, some activities will have an internal cause. For instance, internal support activities—such as those carried out in personnel or IT functions—are generally caused by demand from other departments.

Principle 3: Customers, products, or channels cause different levels of activity.

Traditional costing methods, such as standard or absorption costing, allocate base costs directly to products, customers, or distribution channels. These methods ignore the principle that resources are actually consumed by activities, and not by the products, customers, and channels. ABC allocates costs to customers, products, and channels in line with the proportion of activities they actually consume.

Using ABC Information

Figure 3, below, illustrate how some of the resource costs are allocated to activities. The costs associated with each activity can then be apportioned to customers and products, based on what proportion of the appropriate driver volumes they use.

For some activities, defining a sensible causal link to customers and products is not obvious, or may indeed not be a sensible thing to do at all. For example, most of the activities carried out by an organization's CEO would probably not be attributable to particular products or customers. The right-hand branch of Figure 3 shows "non-specific costs" that cannot be attributed to an activity and have no relationship with customers or products. Expenditure on corporate branding, for example, would fall into this category.

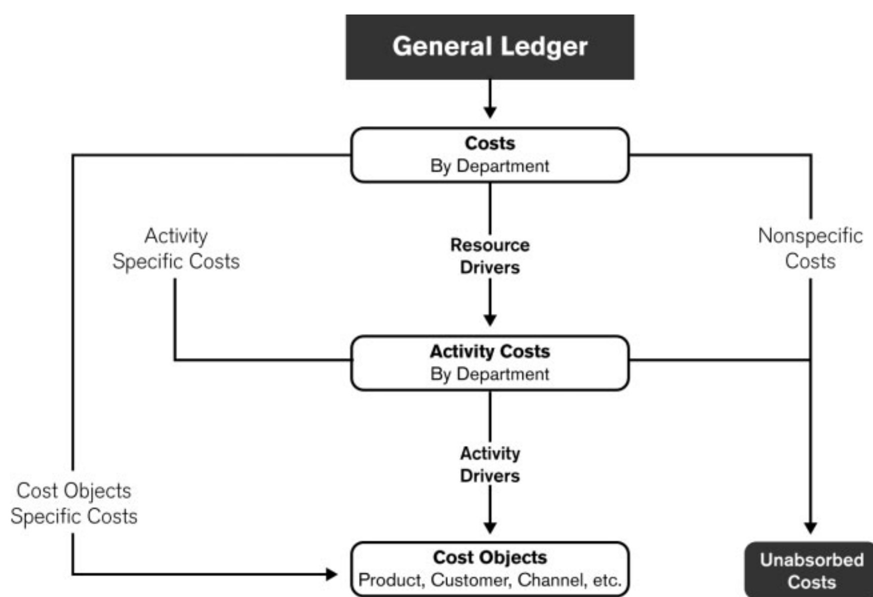

Figure 3. A simple flow of cost in an ABC model.

Sometimes there will be resources that are directly attributable to products, customers or channels, but can't be attributed directly to activities—for instance, the cost of advertising space for a particular product. This cost can obviously be attributed directly to that product, and would not be associated with any particular activity. The left-hand branch of Figure 3 shows costs that cannot be attributed to an activity.

The information generated by ABC has the ability to transform managers' intuitive views of the profitability of customers and products. Having identified the true end-to-end cost associated with each order line on every invoice and having measured the cost of serving an individual customer and supporting each SKU, it's possible to produce reports at any level of detail across any dimension. Users who are seeking information to help them with strategic decisions—such as those involved in product portfolio management—can review data at the highest level. On the other hand, those who need detailed data on individual customers for use in pricing negotiations, or for identifying opportunities for win-win cost savings, can drill down to individual sales-order lines.

One of the more revealing forms of analysis is cumulative profitability by customer or product, ranked by the amount of profit they generate. The chart in Figure 4 shows an example of this.

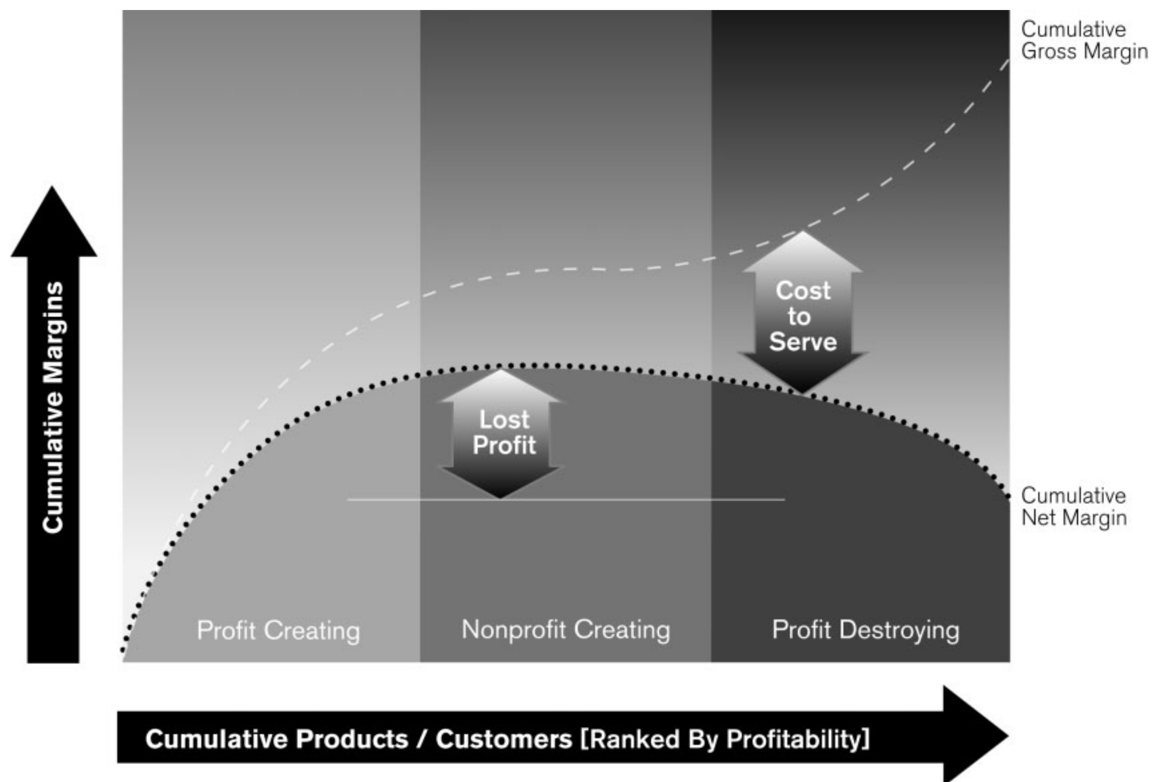

Figure 4. Typical product/customer ranking from ABC reports.

- Customers at the extreme left of the horizontal axis are those who generate profit. Some of these may be large key accounts, but others in this group may cause surprises.
- At the extreme right of the horizontal axis are those customers who generate the largest losses. These may not provide any surprises. However, the detailed information generated by ABC will show whether these accounts are contributing to fixed costs, and will provide considerable insight into ways in which the cost-to-serve these customers can be reduced. Often, it's not a case of abandoning these customers, but working with them to identify more efficient ways of doing business together. Surprisingly, what benefits the supplier often benefits the customer.

Figure 4 also shows the cost-to-serve and the amount of profit lost through selling unprofitable products or dealing unprofitably with customers. The provision of this information should stimulate a number of change initiatives that can quickly bring improvements to the bottom line. These include:

- Having a more informed approach to pricing and discounting strategy, including ensuring that any of the discounts listed in the pocket price waterfall are underpinned by real cost savings.
- Developing desktop pricing models for quoting new business. Alternatively, where pricing software is deployed, these can be populated with accurate unit costs generated through ABC.
- Having a focused strategy for customer management, putting in place programs to defend and develop profitable customers and retrain or rationalize unprofitable ones.
- Providing product management with actionable information on the profitability of products, as well as reliable costs that can help managers better assess the cost of new products and product variants.
- Prioritizing areas for process improvement.
- Having informed, face-to-face pricing negotiations with buyers.

Many of these initiatives will bring quick returns. Other initiatives, such as a series of actions to bring a large account to an acceptable level of profitability, will undoubtedly take longer. However, ABC isn't a one-off exercise, and reporting should be frequent. The advent of web-based ABC has enabled many companies to generate monthly cost and profitability reports, and in certain cases of best practices—for example, a UK-based grower and provider of fresh foods—profitability reports can be generated every week. It will quickly become apparent what frequency of reporting business users need, and whether they value the insight it provides. Once they've had the information, they will never know how they coped before.

Business Objects Solution for Cost-to-Serve

The Business Objects cost-to-serve solution is a real-time, web-based ABC approach that makes cost-to-serve analysis a reality for organizations that are driven by the need for superior management of pricing and profitability. At the core of this solution is an advanced activity-based management (ABM) calculation engine. The graphical web-based interface is used for the collection and collation of data, as well as quick access to the critical cost and profitability information that users and management need. Business Objects expects to see the recent rise in interest in ABC, as a means to deliver cost-to-serve analysis, continue in the coming years—as organizations strive to understand true product and customer profitability, fuelled by the desire to improve their competitive position and the bottom line.

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