Cost-to-serve can help making your business profitable

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The Danish Supply Chain Panel

Surveys of 2017:
1. Digitalization in the supply chain
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4. Cost to serve

Cost-to-Serve Can Help Making Your Business Profitable

DILF and researchers from the Department of Entrepreneurship and Relationship Management at SDU in Kolding conduct each year a number of mini surveys focusing on different supply chain management issues. Respondents to these mini-surveys are voluntary senior managers from various Danish companies represented as the Danish Supply Chain Panel. This article presents the results of mini survey which focus on cost-to-serve.
Introduction
The principal objective for supply chain executives, is to operate and develop supply chains that could meet customers’ requirements and needs. Knowing which customers to work with and which not to work with is, however, not an easy task. Though it has been established by several authors, that this is the key element in obtaining overall profitability for companies (Ryals and Knox, 2005; Homburg et al., 2008). In general, costs for servicing customers are called “cost-to-serve”. In this mini-survey, it means an understanding of the total cost of servicing customers, both at a customer and at a product level so, one is able to evaluate whether the supply chain is delivering the appropriate levels of service to the customers. The cost-to-serve analysis provides unique insights into the true profitability of the customers. Adjacent terminologies to cost-to-serve are customer profitability analysis (CPA) (Niraj et al., 2001), and life-time economic value analysis (Berger & Nasr, 1998). These are also methods used to classify customers in different categories and/or calculate the costs associated with servicing customers compared to revenues generated from them. A crucial part of servicing the customers of companies, is to gain knowledge of the profitability of these. That is, customers are different, as they each demand something different from the focal company’s supply chain. Failing to obtain data regarding customer profitability can lead to spending too much time and resources on customers that are in fact unprofitable, while spending little time servicing customers that are actually profitable (Braithwaite & Samakh, 1998; Guerreiro et al., 2008).

Lapide (2014) operates with the concept of “true customer profitability”. He classifies the total costs into three components:
Supply chain landed costs (product, transportation and activity based costs)

Program and service costs (e.g. vendor managed inventory, just-in-time manufacturing, special handling and packaging, costs of promotions, new product launches, and trade marketing and co-marketing programs)

Financial operation costs (costs associated with carrying inventories from before customer shipments until customer payments are received and costs incurred by an accounts receivable department to invoice and collect payments).

Our experience is that there in many companies often are trench warfare between sales and operations. Sales wants to offer as wide a product program as possible, and operations wants to prune the assortment and perhaps customer portfolio, to reduce complexity. Companies need what can be termed “an attractive assortment process”, which differ from just “an assortment process” by a strong consciousness about its composition (Stentoft, 2015). The assortment must be saleable and profitable when considering the three total costs components. Product development must develop products and services with the right value propositions and the supply chain must secure effective and efficient material, information and financial flow.

On an open question, the panel members have been asked about what kind of tools they use in cost-to-serve/customer profitable analyses. A condensed list is as follows: internal ABC analyses, power business intelligence tool, target BI for axapta, SAP, business warehouse, excel, web-portals, freight per costumer, order handling costs, order sizes, order frequency, shipment cost analyzes, travel expenses, rough ABC analyzes in spreadsheets, gross profit margin pulled from ERP system and customer relationship management systems.

Hidden costs
The panel members have been asked to evaluate to which degree they experience the presence of hidden costs associated with serving customers with products and services. As shown in Figure 2, the most appearing hidden costs are customer service costs and stocking and handling costs with averages above 3.0. In other words,
the practice is that customers are receiving extra services, which they do not pay for, and there might also be special demands for stocking and handling goods, which are part of the sales price. Mapping such hidden cost is often a healthy activity, so communication between sales and operations can be more fact driven instead of being driven by emotions.

**Benefits of cost-to-serve**

As with many other business initiatives one has to make at least simple cost-benefit calculations in order to evaluate whether the investment in the form of time consumption, and out of pocket money match the benefits it will deliver. Therefore, we have asked the panel members to evaluate a number of predefined benefits, and also to evaluate their current practice. Figure 3 shows that a benefit of improving customer profitability obtains the highest average at 3.82 for importance, and 3.26 for their current practice. The second highest is “protecting existing highly profitable customers”. In other words, a structured cost-to-serve approach can avoid cutting profitable products and customers.

Another important benefit is that cost-to-serve also can bring important data to the table in negotiation processes with customers. Again, this process stimulates fact-based driven mindsets. Other benefits are that the process could illustrate where processes needs to be improved, and where re-pricing must take place.

As an example, a small Danish manufacturing company within business-to-business recently implemented a Dynamics NAV system. The implementation also included a shop floor module with time registration of employees and operations, setup times etc. This new system gave the company a new picture of the reality – and also revealing data about which products that were profitable and which were not. Based on the new data, the company raised the price for some products to some customers, where the communication with the customers now are fact driven. For other products, they continued with the price even though it was not profitable; but due to strategic reasons the customer was profitable as a whole - “what you lose on the swings you gain on the roundabouts”. And finally, business with some customers were terminated as the customers could not afford price raisings – and the company could not afford continue selling products with losses.

**Product and customer pruning**

Figure 4 shows gaps between perceived importance of continuously monitoring...
the product and customer portfolios and the actual practice with these tasks. Product pruning activities receive higher average scores than customer pruning activities, which might be due to the fact that it is often less sensitive to prune products than customers. Customer pruning activities as practiced, only receive an average of 2.45, whereas it is 2.95 for product pruning. Dialogue between sales and operations planning is needed in order for silos to be teared down and processes established with a common language (Stentoft et al., 2016).

### Barriers for cost-to-serve

In line with conducting cost and benefit analyses for implementing cost-to-serve techniques and processes, it is also valuable to be aware of potential barriers for making it a reality. The panel were asked to mark up to three barriers from a predefined list of 11 barriers (see Figure 5). The barrier obtaining the highest number of marks is ‘lack of data transparency’. Many companies have much data; but is it the right data? Data might also be stored in sub-systems that are not integrated. Then follows “data extraction is too difficult” and “too few resources” followed by “lack of data comprehensiveness”.

### Conclusion

This article has reported on a mini-survey about the cost-to-serve approach. The survey shows that the concept is being perceived relevant, albeit its practical application halt behind. The most hidden costs reported by the panel, are customer service costs and stocking and handling costs. Top three reported benefits of cost-to-serve are improved customer profitability, protecting existing highly profitable customers, and betterment of the foundations for negotiations with major customers. The panel also report on the importance of pruning both products and customers; however, average scores for their practice are substantial lower than the scores for the perceived importance. The top reported barrier to work with cost-to-serve is lack of data transparency, followed by difficulties with extracting data; too few resources; and lack of data comprehensiveness. As with the other mini-surveys, this paper is based on basic statistic with averages numbers from panel data. They do by no means illustrate “the truth” but provide some indications about the cost-to-serve phenomenon among the panel members that one can reflect upon in own practice. If this paper has stimulated to begin analyzing cost-to-serve, we can recommend using basic mapping exercises of the current value-added process steps, and the different solutions that are provided to customers. The analysis will benefit if being conducted by cross-functional teams. Such processes can reveal shocking results that call for changing ongoing practice to make the businesses profitable.

### References


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