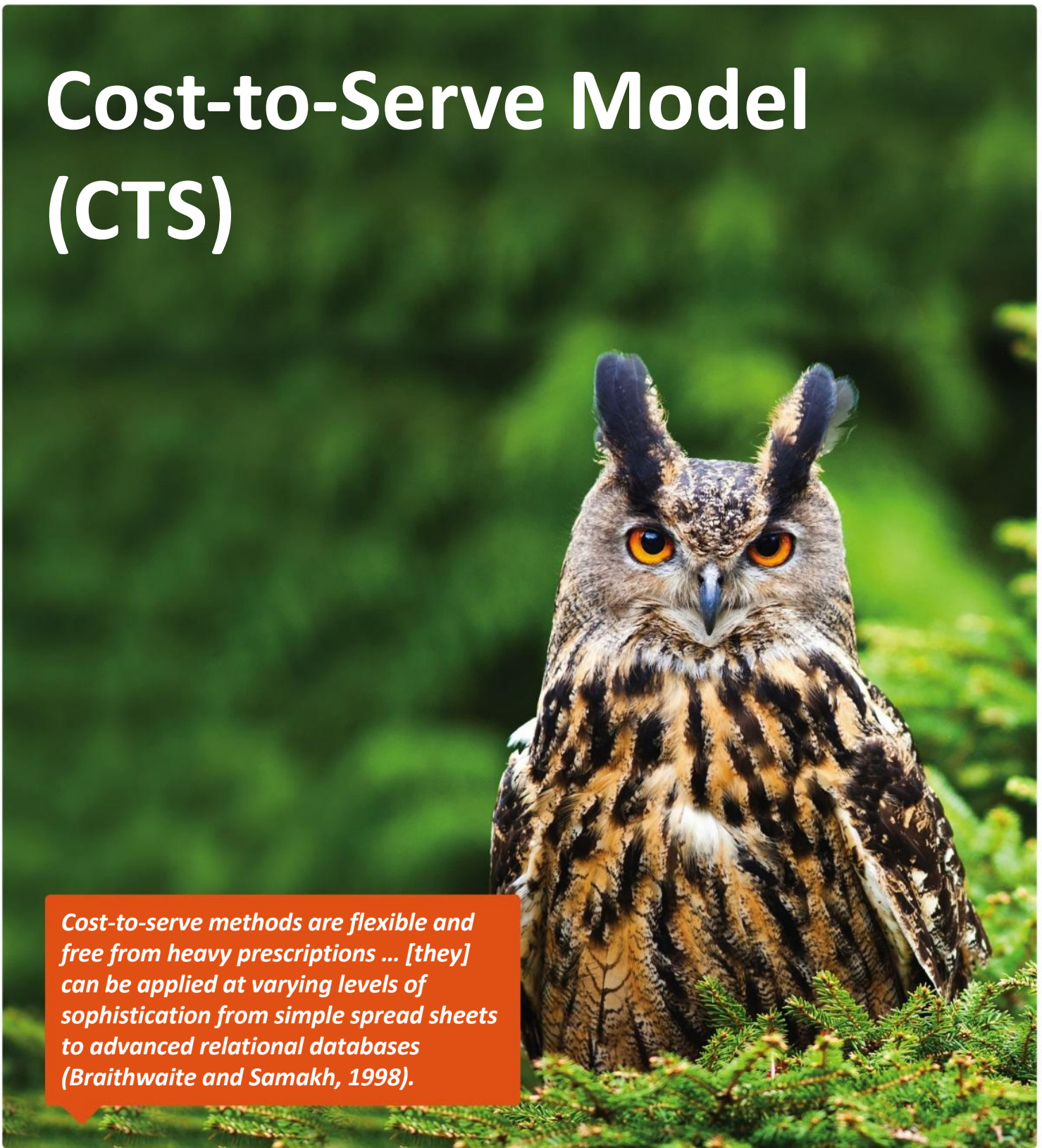


Cost-to-Serve Model (CTS)



Cost-to-serve methods are flexible and free from heavy prescriptions ... [they] can be applied at varying levels of sophistication from simple spread sheets to advanced relational databases (Braithwaite and Samakh, 1998).



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Introduction

The term 'cost-to-serve' broadly describes customer-service costs and was popularised by a few publications (see Braithwaite and Samakh, 1998). In terms of academic research on the subject, the term has been used almost interchangeably across different disciplines with terms such as 'marketing costs' and 'marketing and logistics costs' (Guerreiro et al., 2008). Braithwaite and Samakh (1998) observed that while companies often know in specific detail exact costs for producing a product, they are often less than well-informed about what it actually costs to serve a customer. These authors argued that it is the customer, not the product, that makes the profit. Thus, CTS method is key to understanding customer profitability. At the same time the concept is counter to prominent Harvard Business School strategist Michael Porter's warning to organisations regarding attempting to be low-cost while at the same time differentiated (Kaplan and Cooper, 1998). Recent research shows that organisations can implement CTS to be profitable on all customer segments regardless of cost or product differentiation (Guerreiro et al., 2008).

According to Kaplan and Cooper (1998), tracing activity costs to customers, distribution and delivery channels can help companies achieve opportunities and benefits arising from the use of cost-to-serve models abound. These include: (1) protecting existing highly profitable customers; (2) repricing expensive services based on CTS; (3) discounting (if warranted) to gain business with low cost-to-serve customers; (4) negotiating win-win relationships that lower cost-to-serve for cooperative customers; (5) permanently conceding loss-making customers to rival companies; and (6) attracting high-profit customers away from competitors.

Definition

Cost-to-serve (CTS) is a method for assessing "the sum total of a large number of transaction costs which will vary by product, by market, by channel of trade, and ...will vary between individual customers" (Gentles and Oliver, 1998: 763). It is these specific costs, as opposed to those linked traditionally to distribution cost-cutting programmes, that form the total cost-to-serve and help companies to make more informed strategic decisions (Gentles and Oliver, 1998).

Successful Application

CTS methods are flexible and free from heavy prescriptions for their use. In fact, CTS methods can be applied at varying levels of sophistication from simple spread sheets to advanced relational databases (Braithwaite and Samakh, 1998). For these reasons, CTS methods are not reserved exclusively for large of organisations but can be applied to small and medium-sized enterprises. Some illustrative example of CTS in action can be found in Braithwaite and Samakh (1998); Gentles and Oliver (1998); and Kaplan and Cooper (1998). An important piece of advice given by Braithwaite and Samakh (1998) is that the cost-to-serve process should link back the results to the total cost by function in the business. In doing so, fixed variable ratios can be correctly interpreted and the CTS model is ascertaining and linking the various cost drivers in the right way (Braithwaite and Samakh, 1998).

Steps to Successful Application

- Collect detailed data and carry out analysis to understand quantitatively the major supply chain characteristics.

- Analyse data for key cost driving criteria through a relational database (for example), and then re-compile it at summary level into a spreadsheet. A matrix can be used to categorise customers and identify appropriate strategies.
- Let the vertical axis show the net margin resulting from net sales price after sales promotions, deducting production costs. The horizontal axis presents customer CTSs, including order-related costs, along with marketing, technical, sales and administrative expenses specific for customer support.

Kaplan and Cooper (1998)

Hints and Tips

- Following the data collection stage, the initial analysis might focus on: total flows of products by product group/channel down the supply chain, logistical variety of products within product groups/channels, order and inventory profiles, seasonality/cyclicity, and sourcing, delivery and transportation performance issues (Braithwaite and Samakh, 1998).
- Move beyond simply knowing whether a given customer's cost-to-serve is high or low: final decisions depend on commercial policies adopted in individual cases (Guerreiro et al., 2008).
- Complexity of CTS models depends on the number of channel-product group combinations and so attaining the right level of detail in the model is important. Recognise the variety within product groups and channels but maintain an uncomplicated strategic perspective. As a rule of thumb keep things simple: the simpler the model, the better the conclusions will be (Braithwaite and Samakh, 1998).

Potential Advantages

- The cost-to-serve model can help companies identify unprofitable products and services and make strategic choices about which of these to drop or improve (Braithwaite and Samakh, 1998).
- By using CTS methods to gain information about which products and services to remove or focus on, companies can avoid the risk of 'disappointing their investors' (Braithwaite and Samakh, 1998).
- CTS methods are arguably less resource-intensive compared to activity-based costing methods, although the use of these two methods is far from being mutually exclusive (CIPS: Activity Based Costing).

Potential Disadvantages

- There is some overlap and lack of clarity in the academic literature between CTS and similar terms (e.g., marketing and logistics costs) which has impeded the development of a concise definition (Guerreiro et al., 2008).
- CTS methods can only highlight areas for improvement. The quality and eventual outcomes of these improvements depend largely on managers formulating strategies and carrying these out (Guerreiro et al., 2008).
- Similarly, the quality of analysis from using CTS models depends on the quality of the data collected in the first instance to understand the major supply chain characteristics: data collection and analysis can be time-consuming and resource-intensive (Guerreiro et al., 2008).

Performance Monitoring

- During the initial analysis focus on measures of delivery performance, warehousing performance and transportation performance (Braithwaite and Samakh, 1998).
- Activity-based costing (ABC) measures can be usefully applied in establishing customer cost-to-serve, for example order-related costs, together with marketing, technical, sales and administrative expenses specific for customer support (Guerreiro et al., 2008).
- Use customer profitability analysis with CTS methods to measure and gain insight into three important areas: costs and revenues, risks, and strategic positioning (Guerreiro et al., 2008).

Case Studies

- Gentles and Oliver (1998) describe the case of a food manufacturer which, after a series of cost-cutting initiatives, utilised CTS methods enabling the company to make additional profits of US\$3.8m and adding 1.7% to margin sales.
- A school supplies manufacturer applied CTS to its factories and warehouse facilities which resulted in cutting annual distribution costs by over US\$5m, a 20% total reduction (Gentles and Oliver, 1998).
- Braithwaite and Samakh (1998) applied the CTS method to HiTech, a multinational electronics manufacturer, finding that the cost-to-serve for the business averages 4.8% but disguises a range from 3.8% to 7.6%, double the cost from lowest cost channel (distributors) to highest cost (retailers). Critically, the method revealed that monitors were the low point of HiTech's range whereby sales through distributors made a considerable loss.

Further Reading/Reference

Web Resources

- What is cost-to-serve optimisation
http://www.logisticsmgmt.com/article/cost-to-serve_optimization/
- Cost-to-Serve from Deloitte
http://www.deloitte.com/view/en_US/us/Insights/Browse-by-Content-Type/deloitte-debates/bc25c2f2bc812210VgnVCM100000ba42f00aRCRD.htm
- Freemium business models and cost-to-serve
<http://www.supplychainstandard.com/liChannelID/16/Articles/3724/Building+the+Profit-Focused+Supply+Chain.html>
- Design Rules for Cost-to-Serve Models
<http://quantalyst.com/resources/quantalyst-blog/120-design-rules-for-cost-to-serve-models-.html>

Books

- Handbook of Management, Lock & Farrow, ISBN 978-0566079382
- Purchasing and Supply Chain Management, Lysons & Farrington, ISBN 979-0273694380
- Strategic Procurement, Booth, ISBN 978-0749460228
- Procurement Principles and Management, Bailly, Farmer, Crocker, Jessop & Jones, ISBN 978-0273713791
- Cost & Effect, Kaplan & Cooper, ISBN 978-0875847887

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Video

Innovative example of cost-to-serve in the IT sector

https://www.youtube.com/watch?feature=player_embedded&v=JdjiKwiWhYI

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