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Mastering Cost of Goods complexity in multinational manufacturing

Supply Chain Business Finance

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> *Measurement is the first step that leads to control and eventually to improvement. If you can't measure something, you can't understand it. If you can't understand it, you can't control it. If you can't control it, you can't improve it.*
>
> ***H. James Harrington***

Challenge

For companies with manufacturing operations, Cost of Goods Sold (COGS) is typically considered to be the most complex cost element in the P&L. At the same time, it is often the largest one, offering significant cost optimisation opportunities.

Today we still see a significant number of organisations lacking sufficient transparency and insights into their COGS, restricting their ability to control costs and limiting optimisation opportunities.

Especially with globalisation of Supply Chains, many businesses have evolved since the time they have setup their systems, data flows, processes and organisations. Over the years, quick fixes have often been made in order to resolve pressing needs, which eventually added complexity and disconnect to data flows and financial processes.

Navigation through these complexities now requires dedicated financial experts with in-depth knowledge of these custom-build frameworks.

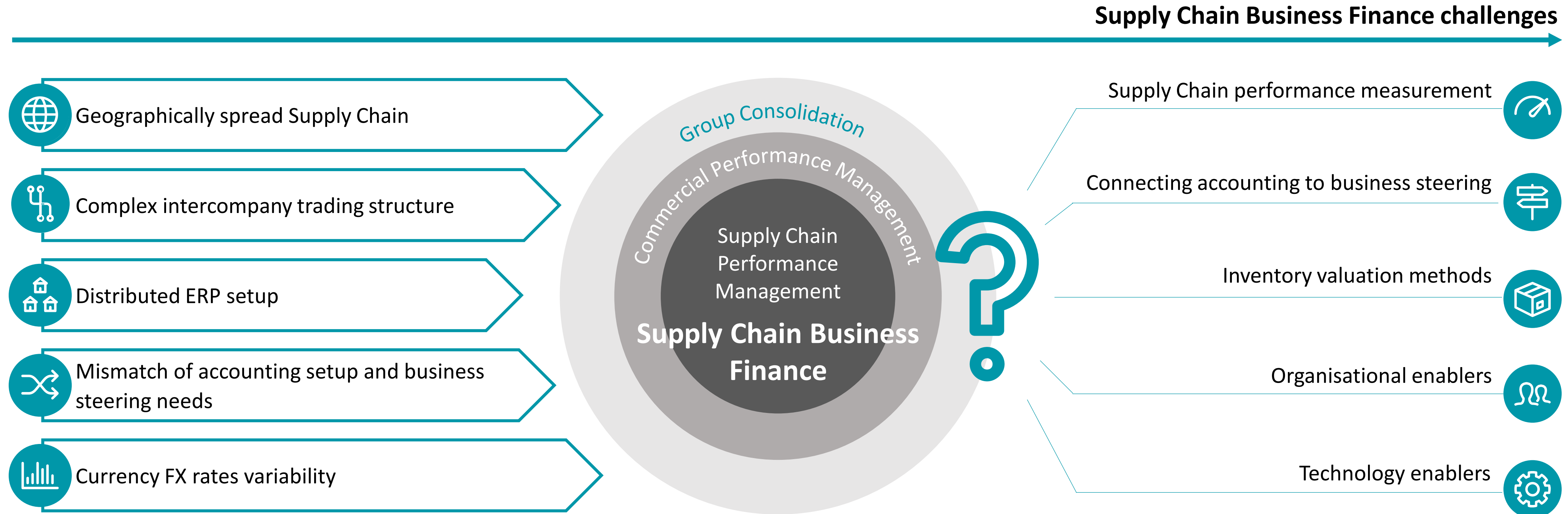
Opportunity

Supply Chain Business Finance function plays an important role in an organisation, covering the following areas:

- Supporting commercial performance management by providing product costs
- Partnering with Supply Chain function to drive business performance
- Enabling accurate Group financial consolidation of COGS and inventories

Leading organisations transform their Supply Chain Business Finance functions by reducing complexity and adopting leading practices. This allows them to improve COGS transparency, upgrade analytical capabilities and refocus efforts from day-to-day data gathering and troubleshooting of accounting or technology issues, to Business Partnering with Supply Chain leaders, adding value to the business.

Supply Chain Business Finance needs to overcome a significant complexity to deliver performance management effectively



Supply Chain performance measurement

Supply Chain Business Finance plays a key role in helping Supply Chain leaders to steer the business. Despite this close partnership, financial information is not always well connected to business KPIs – limiting its use by the business.

Similarly to the Business Finance (or FP&A) function overall, Supply Chain Business Finance is quickly becoming an analytics hub of the Supply Chain organisation. At the same time, it is also developing into a true Business Partner that works closely with Supply Chain leaders to drive and improve financial and operational results.

In many organisations today, Supply Chain Business Finance teams go beyond merely monitoring the financial performance. They also manage operational KPI dashboards, and are heavily involved with business target setting and performance measurement.

However, despite a closer business and finance partnership there are still instances of disconnect between the Supply Chain financial and business KPIs, which prevents business leaders to fully leverage financial performance measures within their business steering.

A financial steering model works well when it is transparent and simple, and when business leaders can see how operational levers are connected to their financial performance. In our experience, it is also important that a steering model clearly defines business financial accountability boundaries as well as avoids distortions by various financial adjustments such as FX impacts or intercompany price variances.

For example, some companies struggle to accurately measure plant production cost financial performance, due to the difficulty of accurately identifying the cost impact of volume and mix variances vs target. Leading companies are addressing this by leveraging Activity Based Costing method.

To effectively operationalise a financial steering model, a Supply Chain financial framework, which sets in action a steering model through accounting and controlling setup, needs to consider the business specifics and connect to cost drivers of different Supply Chain functions, such as direct material procurement, manufacturing operations, and logistics. It is also important that this framework is seamlessly integrated into the financial framework of the whole enterprise, supporting cross-functional alignment.

Our advice: Reshape financial framework into a business steering instrument by connecting it to operational performance drivers

Connecting accounting to business steering

Accounting data at local legal entity level reflects product costs on a statutory basis, including intercompany profits, often making it unsuitable for commercial business steering. Excluding these intercompany profits to enable accurate business steering and consolidated inventory reporting is a common challenge.

Multinational companies frequently leverage transfer pricing models for tax optimisation (e.g. Limited Risk Distributor model), which need to be embedded in enterprise accounting and statutory reporting at the local legal entity level. As a result, accounting transactions reflect inventory and Cost of Goods Sold (COGS) at a legal or statutory value, including intercompany profits.

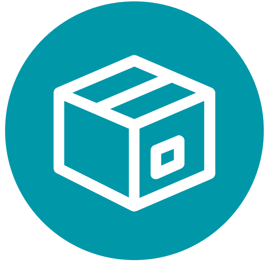
At a Group consolidation level, these intercompany profits need to be eliminated in order to comply with financial reporting requirements, such as the US GAAP or IFRS. While separating and eliminating intercompany profits in a Group P&L can be relatively easy, accurate elimination of intercompany Unrealised Profit in Inventory (UPI) often presents a challenge.

UPI calculation requires transparency within multi-step production processes as well as physical and financial flows of products, spanning across a number of legal entities and countries, involving significant FX exposure. In addition, to steer the commercial side of the business effectively at a global level, there is a need to have another set of product costs which excludes intercompany profits.

In order to address the challenges of Business Steering and UPI elimination, a multinational company typically needs two parallel sets of product costs, reflecting legal and group (or management) valuations.

Leading companies solve this through robust centrally-managed product price and cost data analytics capabilities. By closely integrating management and legal sets of product costs, and aligning physical and financial flows, they are able not only to close the gap between COGS within legal and management P&Ls, but also to support related tax and treasury activities.

Our advice: Set up a parallel management set of product costs, aligning it with legal product costs in order to enable commercial see-through profitability and upgrade corporate finance analytics



Inventory valuation methods

Typically companies employ two inventory valuation methods: MAP and FIFO, based on Standard Costing. Businesses may underestimate the transparency and analytics benefits that the Standard Costing provides, also because it may not be easy to see how the two options it offers can fit into their existing model.

One of the key decisions for a company is related to the inventory valuation method, since it has an influence on many aspects of the financial framework, covering the accounting and controlling setup.

From our experience, multinational companies tend to employ either a Moving Average Price (MAP) or FIFO valuation method, which leverages Standard Costing with FIFO adjustments. We also see an actual costing method being used for countries where it is a local regulatory requirement (e.g. Brazil). In rarer cases it is also used as group-wide valuation method enabled by special technological solution.

MAP's key advantages include simple and low effort maintenance process and real-time reflection of cost changes in inventory and consumptions. Its main disadvantages are a lack of transparency into inventory and COGS valuations, and the complexity it adds to analysis activities. For example, it is a challenge to build an accurate parallel management cost valuation on MAP basis, since it needs to consider global product flows, multiple currencies and FX rate fluctuations.

Standard Costing, although requiring some efforts and discipline, provides transparency into product valuation by setting a reference cost for a certain period. This allows for a more accurate management product cost setting and UPI calculation. An important decision is related to the scope of the cost base covered by a Standard Cost, particularly inclusion of in-bound product freight and duties costs. In most cases we recommend for a Standard Cost to reflect a full cost base, to allow for a more accurate commercial profitability picture and reduce parallel processes needed to reflect excluded costs in the inventory valuation on a FIFO basis.

There are two approaches to a Standard Costing setup: regularly refreshed standard cost (i.e. monthly) and 'frozen' standard cost, typically set once a year. The choice of the Standard Costing method depends on a number of factors, including an enterprise's product profitability level, business operating model and manufacturing strategy.

Regularly refreshed Standard Costs reflect product valuation on a close-to-actual basis. This is highly valuable for industries exposed to fluctuations in commodity prices and where there is a need to accurately assess customer order profitability for the purpose of market pricing.

The 'frozen' Standard Cost method works well for mass-production businesses with fixed pricing. It adds value to Supply Chain steering through forward-looking cost target setting and deviation analytics. This method also helps commercial teams to have a stable product cost throughout the year supporting their focus on driving sales performance.

Standard Costing is sometimes blamed for providing motivation to drive up plant production activity beyond an optimal Supply Chain level. This is typically not an issue these days as close partnering of Supply Chain Business Finance with operations allows a balanced perspective on Supply Chain KPIs across functions.

Our advice: Leverage a standard costing method which fits your operating model in order to improve COGS transparency and financial business steering

Organisational enablers

Supply Chain Business Finance activities are sometimes considered as best performed locally due to a need of business proximity, restricting centralisation opportunities.

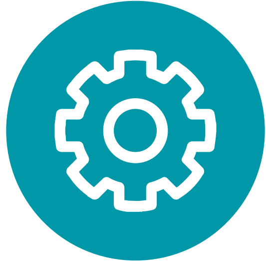
Typically, product costing and Supply Chain controlling activities are quite time consuming and require teams with strong expertise, systems and process knowledge. A good example of how companies address this challenge is by leveraging centralised delivery models.

These models enabled by a global or regional Product Costing Centre of Excellence (CoE), help to absorb the routine work from local and global Supply Chain Business Finance teams allowing them to focus on Business Partnering.

Furthermore, the concentration of these cross-geography activities within a central team provides knowledge continuity, drives standardisation and best-practice sharing, resulting in improvement in data quality and process execution. Additional benefit is that the scale of a CoE also allows to build advanced analytical capabilities, which decentralised teams usually cannot afford.

These focused CoE teams with concentrated specialised expertise can help to not only realise one-off efficiency benefits, but also drive continuous improvement on a systematic basis.

Our advice: Set up a Product Costing CoE to drive continuous process optimisation and quality improvement, supporting the function's focus on value-adding Business Partnering



Technology enablers

Supply Chain Business Finance capabilities are highly dependent on the technology landscape, spanning ERPs, data platforms, Product Costing and Financial Planning & Reporting tools. A single-instance ERP platform can bring major improvement in data transparency and process automation, but requires time and significant investment.

Technology supports standardisation and enables automation in Supply Chain Business Finance. We often discover that a key driver behind a manual workload is a lack of integration of multiple legacy systems.

The company's ERP technology landscape usually sets the foundation for all the systems, and can play an enabling or a limiting role. An integrated ERP landscape significantly simplifies data flows and reduces manual processes.

Some ERP solutions, when employed on single single-instance platform across whole enterprise, provide both legal and management product valuations for COGS and inventories, supporting transfer pricing and enabling see-through profitability (for example SAP's Material Ledger module).

In case of fragmented ERPs, companies can leverage centralised data platforms, data lakes, BWs and Master Data Management tools, which enable transactional data extraction and its harmonisation into a Single Source of Truth. Unfortunately, that does not address the Business Steering and UPI elimination requirements mentioned in 'Connecting accounting to business steering' section, as only the legal product valuation view is available at transactional level.

In such cases there is often a need for a complementary Product Costing analytics tool. These tools typically enable parallel management product valuation not only for actuals, but also for plans and budgets. Companies tend to approach Product Costing tools development in different ways, reflecting specifics of their business and financial setup. Although many existing solutions are custom-built, some also use off-the-shelf tools, which follow common principles. Currently, at Deloitte we are also exploring the potential of Blockchain technology for UPI calculations.

Financial Planning & Reporting tools, in addition to planning functionalities, combine planned and actual transactional data, and provide analytics to support both the legal and management financial views. Modern tools also link into enterprise's Integrated Business Planning and enable automated rolling-forecasts leveraging a driver-based approach for a Supply Chain cost base.

A key differentiator of leading companies is a fully integrated Supply Chain Business Finance technology landscape, covering the elements described above. When built along a well-designed end-to-end financial framework it will drive process automation, enhance transparency and expand analytical capabilities.

Our advice: Build an integrated technology landscape to boost automation and upgrade analytical capabilities… and dare to look into new technologies such as Blockchain

Author

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Konstantin is a Supply Chain Business Finance expert in Deloitte's Finance & Performance team.
He helps clients connecting Finance, Business and Technology aspects along leading practices. Konstantin has led Finance transformations with an emphasis on Supply Chain Business Finance optimisation and digitisation, Business Finance strategy and Centres of Excellence. Prior to his consulting career, Konstantin served for 20 years in Supply Chain (Operations) Controlling and FP&A roles in manufacturing companies.

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