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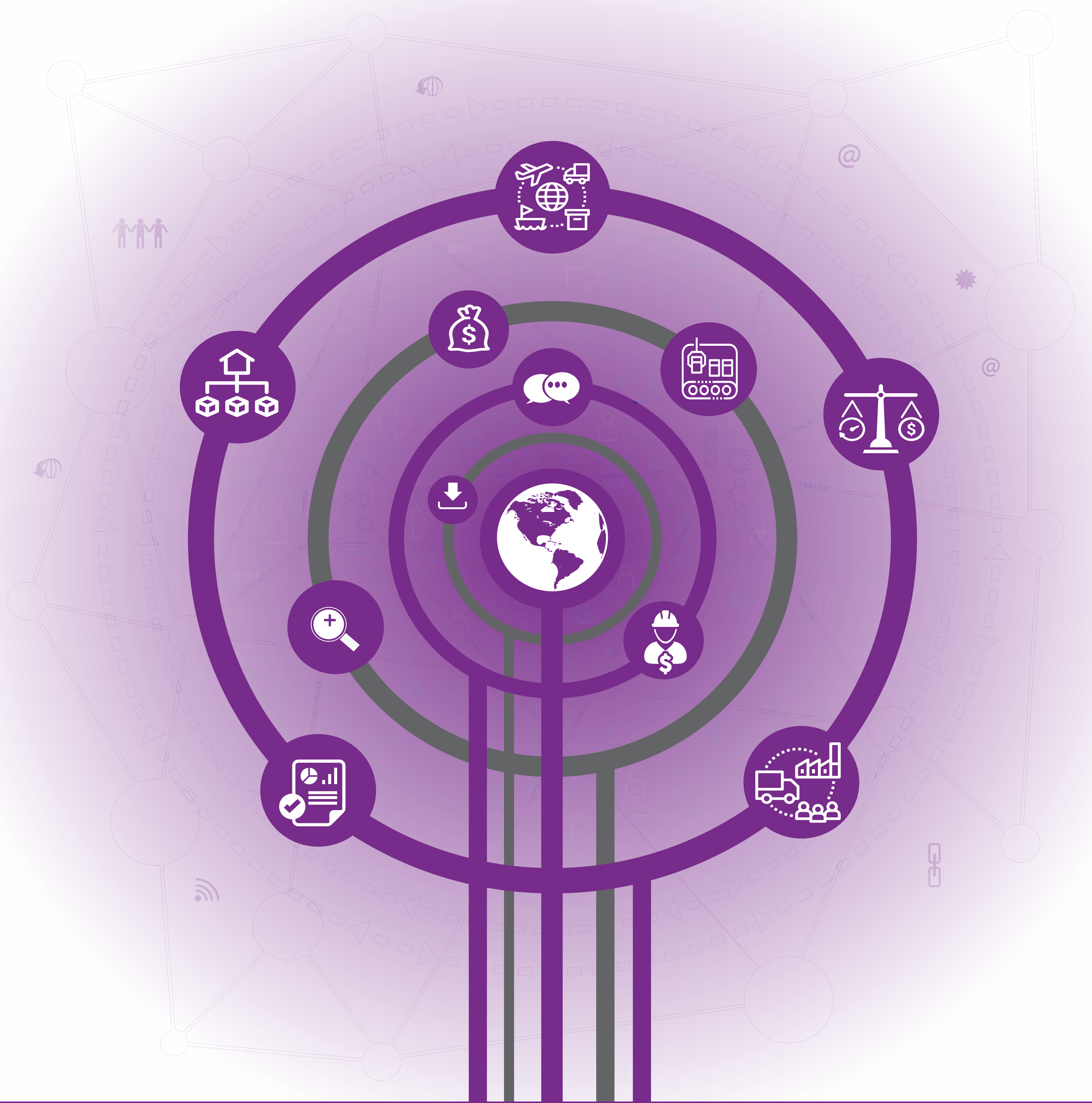

# From data points to dollar signs

Integrating finance with supply chain by getting the CFO involved in S&OP.

# Executive Summary

If you would ask your supply chain team for exact numbers concerning the costs associated with material purchase, inventory holding and logistics, chances are that they will not have an answer ready for you.
The same goes for questions concerning the extra cost of promotions.

This mostly has to do with the fact that, in many companies, the supply chain and finance departments still work in silos and only occasionally interact with one another. Close collaboration is often limited to the annual or quarterly budget meetings, while both teams could profit greatly from the transparency that comes with working closely together. As you can imagine, it is nearly impossible for the supply chain teams to take the financial implications of their decisions into account when they have no insight in the financial situation or planning.

Possible consequences of this lack of collaboration are visible effects on the incremental variable costs, problems with planning and inventory, small gaps in data that lead to miscommunications and inefficient use of warehouse space; which all lead to extra (unforeseen) costs.

Reconsidering the timing of promotions to overcome capacity shortages may lead to a more profitable situation, as well as procurement planning, volume allocation, changing the product mix and adding extra warehouse space and finding an alternative use for the warehouse. However, in our experience, it is the involvement of the Chief Financial Officer (CFO) that really makes a difference. The CFO does not only represent the financial team, but has a 360-degree view of the company's financial situation.

So if you are a CFO or supply chain manager, please download and read this white paper in which we will look at some of the reasons why it is so hard to include the financial perspective into supply chain planning and Sales & Operation Planning (S&OP) in particular. We will also make recommendations based on our experience in making S&OP a process that truly focuses on the bottom line.

# Working in silos

In many companies, the supply chain – of which the S&OP process is an important part – and finance departments still work in silos and only occasionally interact with one another.

Close collaboration between the finance and supply chain teams is often limited to quarterly or even yearly budget meetings, during which the demand and production volumes are measured against the financial projections.

The problem lies in the fact that the supply chain team makes tactical and strategic decisions a lot more often than during those sporadic synchronizations. Sometimes these decisions have negative financial implications and would benefit from external insight and advice from the team that is responsible for the company's cash flow and financial health.

Without consulting the financial team, the supply chain team might for example decide to produce ahead of time to meet sales requirements and to ignore the impact that this might have on the inventory costs or the risk of overproduction, which may result in obsolete stock.

# Implications for the S&OP process

Even though the problem can be explained in one or two sentences, the consequences of these problems are a little more elaborate. The supply chain and financial team's lack of communication has implications throughout a large portion of the S&OP process.

**Incremental variable costs**

When making tactical and strategic decisions within the supply chain, it is essential to know the incremental variable cost at each step of the way. After all, the incremental variable cost is what drives the decisions to purchase, produce or transport.

However, supply chain teams often find it hard to procure the exact incremental variable costs from the finance teams. An often-heard reply to a supply chain request for information is "it depends". The definition of incremental variable costs depends on how it gets used; it depends on how the fixed costs are allocated; it depends on when the costs are tallied up; it depends…
This discourages the supply chain team and also leaves them deprived of the information they need to make informed decisions.

**Planning and inventory**

Procurement planning is the process of deciding what to buy, when and from which source. When looking at the process industry for example, one or two key raw materials represent a major component of the production and inventory costs. In such conditions, when the price of such a raw material goes below a certain threshold, the immediate reaction is to buy and contract more than is strictly necessary to meet the demand.
As the future unfolds, the excess purchase can prove to be a bad decision due to additional storage costs.

**Small gaps in data**

The lack of communication between the financial and supply chain teams may lead to small gaps in data. These gaps may in turn lead to both teams distrusting the data, while in reality the results merely represent two sides of the same story.

**Product mix**

When faced with limited production capacity or natural limits to the annual procurement of raw materials (e.g. fish or field crops), a business needs to decide the product mix that provides the best return on investment (ROI).
With the involvement of the financial team, the supply chain would be able to make more informed decisions when it comes to the best possible product mix.

**Warehouse space**

Keeping assets loaded makes sense in a 3 to 6 month timeframe, because it will not be possible to get rid of the associated fixed costs for such a short period of time. However, if assets run at a loss, it does not make financial sense to keep them. This is one of the reasons that many companies no longer own their manufacturing assets.

Besides this, a lot of companies have seasonal demand peaks and need to build stock to cover the demand during these peaks. Since they anticipate the inventory build, the supply chain team may contract external warehouse space, but has no use for that extra space when the seasonal peak has ended.
The financial team now has a problem, because they are stuck with paying for warehouse space that the company won't be using until the next holiday season.

**Volume allocation**

Along with product mix optimization and available warehouse space comes the challenge of deciding how to allocate the volume amongst the different production facilities in the supply chain.

With other costs being based on the company norm, the transportation and storage costs may drive the allocation of production volumes to the plants.

# Getting the CFO involved

**Incremental variable costs**
When the CFO gets involved with the supply chain process, he will be able to make adjustments to provide accurate incremental variable costs, which leads to better decision making.
Some common decisions that we have seen include buying materials at a later time at a higher cost; missing out on pre-order discounts; and producing later. This results in higher labor costs due to overtime, but decreases the utilization of the warehouse and transportation costs, or both. Some decisions may cost a little more and seem counterintuitive, but in the end it is the total cost that matters.

**Planning and inventory**
Reconsidering the timing of promotions to overcome capacity shortages may lead to a more profitable situation. Another option is to implement software, like our Outperform Planning solution, that helps with planning the supply chain and the S&OP process.
It also generates advanced analytics that provide insight into your inventory and budget. This software can act like a tool that represents the interests of both teams. However, in our experience, software can only get you so far, it is important not to lose sight of the human component: the CFO.

### Small gaps in data

Small gaps should not be the reason to distrust data. The CFO would be able to provide insight into where the discrepancies come from,
hold contributors accountable and make sure that all parties involved understand why the gaps are not a trustworthy factor by which to judge the current situation.

### Product mix

Producing and storing a mix of products becomes a complex computation when rule-based limits like manufacturing cycles come into play and when the hard limits in the supply chain are treated as soft constraints at additional costs.
The CFO should be able to provide insight and be able to see the bigger picture by including customers' favorites into the equation, optimizing across the collection of products that customers are buying.

### Warehouse space

The CFO can play a pivotal role in explaining how the impact of being financially efficient in one area of the supply chain will benefit other areas.
The CFO can also represent the strategic perspective on the cost of tying up capital in the supply chain, which reduces flexibility throughout the whole company.

### Volume allocation

When it comes to volume allocation, it is paramount that the costs are reviewed on a regular basis.
The CFO should arbitrate to prevent that fixed costs are allocated creatively to influence volume allocation decisions and true incremental variable costs is the basis for the plans, which translates into more profit.

# The CFO

The structure of costs maintained by finance is not always directly compatible to the needs of the supply chain. Costs are based on production on the preferred resource or reflect the average across all possible recipes and routines. The CFO will be able to shed a light on the financial intricacies that drive certain decisions. This is why the true solution lies in involving the CFO in the supply chain process. The CFO does not only represent the financial team, but the whole financial situation of the company. He will understand the "it depends" conditions that we have mentioned earlier, will act as a tour guide in the unknown financial landscape and will have an open mind that goes beyond dogmas like "we must buy now because it is cheap". The CFO will also scrutinize assumptions, ensure that the fixed cost allocation is not used as a tweak factor to win volume allocation and point out where the supply chain can – and should – save on stock, manufacturing, inventory and logistics.

## *Recommendation*

*We recommend that the supply chain team has a regular meeting – preferably weekly, but at least monthly – with the CFO in which all supply chain and S&OP decisions that might have financia implications are discussed. What is missing from the equation is the regular, scheduled revisiting of the cost allocation each month, and sticking to those meetings. When this becomes routine, it can introduce variations in areas that are normally kept fixed to suit other purposes and thereby allowing for more flexibility throughout the company. If these meetings prove difficult to plan due to conflicting schedules, at the very least have the supply chain team send an email to the CFO, asking for advice and insight.*

*Of course, the finance team should actively reach out to the supply chain team as well. Offering the committed supply chain professional more training in finance will provide him with knowledge and skills that will quickly prove their added value when applied to the S&OP process. To overcome resistance from the accounting team and/or controller the CFO will need the support of the CEO.*

# Conclusion

Obviously, taking the financial implications into account when it comes to decisions concerning incremental variable costs, product mix, inventory storage and volume allocation is mportant and will help with the numbers adding up by the end of the year and generating (more) profit. As we have explained, this is only possible when the finance and supply chain teams have regular interactions.

When handled correctly, interdependence between various functions and processes represents sizeable opportunities for improving the bottom line.
Actively involving the CFO in the supply chain process will ultimately lead to an efficient use of resources, which in turn will lead to more profit. It is well worth the effort bringing the finance and supply chain teams together. It takes between 3 – 4 cycles for improvements to start being visible, spending roughly 16 hours each month.

To gain further insight in how your organization can achieve integrated Sales & Operations Planning and true collaboration between supply chain and finance teams, contact our sales team via sales@outperformplanning.com or via www.outperformplanning.com.



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