Reducing costs through collaboration in the supply chain

In these uncertain times, with many economic challenges ahead, the need to contain costs across the business is as strong as ever. As the world emerges from the economic downturn, there are worrying signs that input costs, particularly raw materials, are on the rise again. Against this backdrop, the search for cost reduction opportunities is intensifying

By Martin Christopher

The problem of containing costs in the supply chain is that after many previous programmes to 'lean down' the business, there are fewer low hanging fruit left. However, there still remains one last major opportunity to take out costs – not from inside the business per se, but rather from the interfaces with other partners in the supply chain. The rationale behind this assertion is that for most of their existence, firms have focused on seeking internal efficiency improvements and have often failed to recognise the significant layer of cost that exists at supply chain interfaces – a cost that is there because those interfaces have not been well managed in the past

Supply chains compete, not companies. It has often been the case that relationships with suppliers and even customers have been, at best, at arms-length and at worst adversarial. It is still the case today that some companies will seek to achieve cost reductions or profit improvement at the expense of their supply chain partners. Companies such as these do not realise that simply transferring costs upstream or downstream does not make them any more competitive. The reason for this is that ultimately all costs will make their way to the final marketplace to be reflected in the price paid by the end user. Smart companies recognise the fallacy of this conventional approach and instead seek to make the supply chain as a whole more competitive through the value that it creates and the costs that it reduces overall. They have realised that the real competition is not company against company but rather supply chain against supply chain

Cost reduction opportunities. There are three key drivers of costs, albeit related, at most supply chain interfaces – all of which can be eliminated by collaborative working. These costs might be labelled: transaction costs; process costs; and uncertainty costs

Transaction costs

These are the costs of placing orders, progress chasing, raising invoices, confirming delivery arrangements, handling queries and all the myriad of other activities that are involved when companies do business with each other. Many of these costs are hidden and not easy to quantify and yet they can be significant.
However, in many cases, they can be dramatically reduced by the adoption of collaborative working arrangements supported by modern B2B e-commerce tools. Today's information and communications technology has made it possible to connect supply chains from one end to the other and the availability of

Software as a Service (SaaS) over the web means that the costs of communication across networks are relatively low. The barriers to improving supply chain collaboration to reduce transaction costs are not actually to do with technology – rather they are to do with mindsets. In other words, there is still often a reluctance to work as partners and hence to share information across the network. Research has highlighted the significant benefits of reduced transaction costs, shorter cash-to-cash cycles and improved supplier/customer relationships that can be achieved if the barriers to collaboration can be removed

Process costs

These costs arise because suppliers' processes do not always align with those of their customers. Thus there are often considerable inefficiencies at the point of contact. At the extreme case, if the different parties use different product codes or have different unitisation requirements (for example, different pallet sizes), there will obviously be additional costs. However, the lack of process alignment generally means there will be discontinuities and duplication, for example, having to re-enter data several times as orders and products flow from one supply chain entity to another. As well as the time involved, the opportunities for errors to creep in are increased, leading to further cost in the supply chain. Closer process alignment can be achieved through the creation of joint process teams with members drawn from both sides of the customer/supplier interface. Many good examples exist in the consumer packaged goods industry where manufacturers and retailers have created teams to implement collaborative planning, forecasting and replenishment (CPFR) initiatives

Uncertainty costs

These costs arise because there is often a lack of confidence in forecasts and a lack of knowledge about customers' precise requirements. Hence, as a result buffers of inventory are created at the interfaces between supply chain entities. Safety stocks are necessary because of uncertainty and/or lack of confidence in a forecast on the one hand and the supplier's ability to supply on the other. As a result of this uncertainty it is quite common to encounter a high degree of duplication of inventory. In other words the supplier is holding inventory because they are not sure when the customer's order is coming or the size of that order. At the same time the customer is holding inventory of exactly the same material/product because they know from past experience that they cannot always rely on the supplier to deliver what they want, when they want it.

The true costs of inventory are much higher than most managers believe. Because inventory is a part of the total asset base of the business it has to be financed just like any other capital element. Given the current problems many companies have raising capital – be it from banks or investors – it must also be recognised that the opportunity cost of locking up working capital in the form of slow-moving inventory does not make sense. Furthermore, in today's turbulent marketplace and ever shortening product lifecycles, the risk of obsolescence is high – meaning that markdowns or even write-offs are more likely. Combine all these costs with the more obvious costs of storing, handling and managing inventory and it is not unusual to see the real cost of holding inventory approaching or exceeding 25 percent per annum of its value. Thus holding an item of even just moderate value inventory for only a month or so can be enough to wipe out the margin on its sale.

Improved visibility The key to reducing these unnecessary buffers of inventory is clearly improved supplier/customer communication. The old cliché 'substitute information for inventory' has never been more apposite in today's business environment. Those companies that have created improved visibility by giving suppliers information on their rate of usage/sales of a product in as close to real-time as possible, enable vendor managed inventory (VMI) and have been rewarded with a significant reduction in inventory and hence cost

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FREEDOM DAY 27TH APRIL

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FREEDOM DAY!

"For to be free is not merely to cast off one's chains, but to live in a way that respects and enhances the freedom of others." - **Nelson Mandela**

Happy Easter holiday (18th - 21st April)

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