High Cost of Goods Sold

Situation

Your data has identified an opportunity that contains High Cost of Goods Sold as a percentage of Price, so what do you do next? In many businesses, Cost of Goods Sold (COGS) fall in the 20 to 60% of sales revenue range and lead to both margin variation and poor margins over time. COGS is the expense a company incurred in order to manufacture, create, or sell a product. It includes:

- Raw Material Costs
- Processing Costs
- Fixed Overhead Costs

Raw Materials have continued to be a source of margin leakage in recent years due to some of the following reasons:

- Fluctuating and rising commodities markets due to:
  - Increased demand from China
  - Supply shortages across many commodities
  - Increased demand for commodities as many economies recover from recession
- Rising fuel costs affecting both processing and plant overhead costs
- Increased processing costs due to rising wages and reversal of outsourcing trends, in some cases

This paper provides recommendations on how to remedy High COGS as a percentage of Price.

Recommendations

High COGS can be remedied in the following ways:

- Reduce the Root Cause of High COGS
- Close the Gap on High COGS

Reduce the Root Cause of High COGS

While members of Commercial Operations teams would not normally be expected to make sweeping changes to your sourcing and manufacturing strategy, there may be ways that you can collaborate with other teams to reduce some of the contributors to High COGS.

Condition	Action
High COGS due to Raw Material Costs	☐ Renegotiate for lower raw material costs. ☐ Communicate to customers the underlying raw material increases through newsletters and sales materials. ☐ Shift customers to lower cost replacements at higher margins where possible.
High COGS due to Processing Costs	☐ Consider upgrading or replacing equipment to be more cost effective.
High COGS due to Fixed Overhead Costs	☐ Rethink the size of the plant or warehouse. ☐ Re-evaluate advertising and promotions as well as utility contracts, like phones and office equipment.

Close the Gap on High COGS

For the Commercial Operations Team, closing the gap on High COGS is generally an easier task to tackle as these recommendations are small tweaks. These recommendations are generally dictated by business practices.

Condition	Action
High COGS due to Raw Material Costs	☐ Implement index-based pricing, which uses external market indices to calculate Customer Negotiated Price. ☐ Raise Invoice Price or lower Discounts for a product line or a segment to better recover COGS. ☐ Implement more frequent price increases for a product line or a segment in fluctuating markets.
High COGS due to Processing Costs	☐ Evaluate product allocation and pricing decisions based on a Profit Velocity metric, which measures how much profit per hour your equipment produces.
High COGS due to Fixed Overhead Costs	☐ Reconsider the following changes to your strategy for pricing and selling specific products in particular plants: • Price small batches at higher prices than you are currently doing to better absorb high Fixed Overhead, and be willing to drop prices for larger batches. • Consider a minimum batch size on orders of identified products, or institute a surcharge on small batches. • Consider raising prices on custom products, special orders, spare parts, and low inventory items.

Blindly employing index-based pricing across product lines and segments is not recommended. Instead, examine each product line in detail, evaluate current and desired customer portfolios, and pick a desired range of exposures to index based pricing. Use index-based pricing where you are unlikely to realize strong margins over the cycle, and then vigilantly measure margins on indexed vs. freely negotiated volumes. Do not use indexing where you have a specialty value proposition or relationship or have high service costs.