

Finding the Right Inventory Level Is Hard Work
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Distributors are always challenged with the cost of managing inventory. For those multiple branch operations, determining what to keep on the shelves is a much greater challenge. Often this single largest asset grows into the millions seemingly overnight, and one is left with asking “how did all this stuff get here?” It is not hard to let your inventory grow rapidly if you don’t put controls in place during the purchasing process. The excitement to grow bigger, expand into new territories and take on new product lines always results in an exponential growth of your inventory. Sure you might anticipate some growth as you decide to expand, but soon that growth becomes a monster that has to be tamed. For those distributors doing just annual inventory counts, they are often shocked once a year at what they really have in their warehouses. They will ask, “how did this stuff get here?” The answer is a common one: “I dunno!”. Obviously someone had to place a purchase order with the vendor at some point in time, but their name suddenly escapes everyone. Often the culprit has moved onto a new role in the company, or has left your employment leaving you with a warehouse full of stuff. You can take steps to help control the monster living in your warehouse from creating offspring by using some strict guidelines in the purchasing department.

While it never seems to be obvious in the beginning, the number one cause for dead stock is the poor purchasing of new items added to stock. Excitement and anticipation is at an all time high for everyone, except the buyer. They often are just guessing on what quantity to order in those first couple of purchase orders. Management, vendors and sales people all have the same thought...“these will sell like hot cakes!” However, one factor to consider is that for them to sell the hot cakes, your customers need to know about them, see them, touch them and play with them. That takes time, and during that period of creating market awareness, those items often sit around waiting to be picked packed and shipped. In addition, many new items must be bought in large minimum quantities to get a good price, thus helping the sales people move them into the market space. Beware of vendors who combine new items with old stuff, sort of a packaged deal. What happens to your inventory in those situations? Well, maybe the “hot cakes” sell like they should and your investment really generates additional sales and gross margin dollars. That is great, but what about those other items that you took on to get the “hot cakes”? Who is selling those items? Who is managing their movement? Worse yet, who is paying for them to sit around the warehouse collecting dust? The answer is always the same: “distributor is via the annual carrying cost of inventory”!.

New items often have a life cycle that starts fast and furious. Excitement is running high because there is a focus on the new items. Everyone is talking about them to every customer, creating a market for them if possible. For the next few months, these new items are the topic of most sales meetings. Purchasing is sending in

purchase orders to get more and more of the product, but without substantial historical usage. They are kind of guessing their way through it. They talk to the sales people to gather input, and the sales people tell them the old hot cakes story one more time. In essence, with new products, you are having your sales people doing your purchasing for you. Sure they might not be building the purchase order and sending it to the vendor, but the quantity ordered is mainly from their input. A few months go by, and the excitement has waned a bit, as another new product comes to the market. The cycle for that product begins, but there are shipments of the “old new item” on their way to your warehouse. Soon sales of those items begin to find a settling point, while the next new item takes center stage.

As you can see, new items only add to the headaches. However, all inventoried items need a team of people to find the perfect stocking level. I always suggest that the purchasing manager, the warehouse manager, the controller and the sales manager develop a plan and pro forma budget for all items. This would include developing a life cycle based on the history of all products over time. Items such as the initial cash investment, current market conditions, the space requirements in the warehouse, any special pricing or packaging required, and seasonality must be considered. Of utmost importance, is a pre-negotiated return policy to the vendor when items fail to sell as planned. Every new item brought into inventory has to have a predefined disposition other than through sales. You must negotiate how long you will bear the cost of the investment. It might be three months or six months, but less than a year. If sales are not up to your pro forma numbers, then you should have negotiated to return them at little or no cost. Hey, you took some risk up front, and you did your best to create a market for the product, but sometimes it just doesn't work out.

The controller will keep an eagle's eye on the sales and cost numbers for you each and every month. The purchasing manager will not place another purchase order with the vendor, until they spend time with the controller. The sales manager will need to be kept in check based on the actual profit margins. The warehouse manager will provide the details on available space, ease of shipping and accuracy of shipments from the vendor. If they do cycle counting, they will also make you aware of the status of all items. It is a hard rule in purchasing that relatively new purchasing personnel should never be involved in the ordering of new items or seasonal items. These items are tough enough to manage for the most experienced buyers, therefore don't put a rookie on the job that requires the skills of an all pro player.

Establishing correct inventory levels for both old and new items is a daunting task. Most distributors have implemented good software to help them, but sometimes that is not enough. Software uses a series of metrics to provide variances, exceptions and recommendations. Finding the right inventory levels for each and every product in each and every location requires much more. First look at the sales (or hits) of each item in every location. Run the report on a rolling 12 month basis to take into account seasons, peaks and valleys. Look at the trends and explore the swings.



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Compare the sales with the cost of goods sold, the realized gross margin dollars and the current inventory status. Calculate your current “months on hand” (use weeks if that is easier), to see how long you can expect to be in an out of balanced position. Now, take this report, and work from the bottom up. Those items with little or no sales activity, but current on hand quantities need to be dealt with immediately. They are the ones causing some of your biggest hassles in terms of cash flow, warehouse space and allocation of monies for other good movers. Your first task is clean out these items and recapture your cash invested. Remember you are paying a annualized carrying cost of roughly 25 to 30% on all quantities on hand.

Once you’ve cleaned up your inventory using a hits report, you should establish strict ordering controls to keep the inventory monster under control. Using order points, line points minimums and maximums, you can keep things in check. Following the rules of the Economic Order Quantity or The Class Method of Replenishment, you will buy quantities that actually match up with your current sales. The goal is to keep your inventory levels in line with your sales and market conditions. New items require lots of human intervention, as the systems metrics have little information to guide you. Seasonal items need to be flagged in the system, and managed using both the system metrics and experienced personnel’s guidance. In most cases, your inventory levels will ebb and flow as your actual usage rates move. Of course, your safety stock allowances will help prevent outages if managed correctly. Mere guessing or gut feelings when purchasing will definitely not work in today’s competitive market. This is true even for items that appear to have constant and consistent monthly usage rates.

Finding the correct inventory levels is a combination of system used metrics and human intervention. It requires the input and effort of all personnel. It cannot be handled by just one person or just those in purchasing. Don’t leave it to chance, as it will cost you more money than ever imagined.