Balancing Between Inventory Turns and Customer Service

White Paper

By Jason Bader

"In uncertain economic times, the distributor who balances their inventory asset will be in better shape long term that the organizations who panic and make short terms decisions."
- Jason Bader

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For the Distribution Industry

As I sit here reviewing the economic turmoil of the last several years, I can't help but consider how my distribution clients are reacting to the news. Without a doubt, many are finding themselves very wary of borrowed money and looking for ways to bring cash back into the organization. As I have mentioned in several articles, the biggest cash asset in a distributors business is inventory. This appears to be the logical place to start shoring up the reserves. I would definitely encourage our clients to look at prudent reductions in inventory. Most distributors hold at least 30% more inventory than necessary to keep up with current customer demands. It is the panic based reductions that I want to caution distributors against.

When I work with clients, one of their greatest concerns is the turning of inventory. This seems to be the prevailing metric associated with a healthy organization. The conventional wisdom appears to say that the faster you turn the inventory, the better you are. In fact, many organizations have developed incentives based solely on turning the product. While turns should be part of a compensation strategy, it can't be the only thing we measure.

Just so we are all on the same page, here is a quick clarification of the inventory turn ratio. Inventory turn is a measure of how well your inventory investment is performing financially. To determine the inventory turn in your business, take the annual cost of goods sold from stock sales and divide it by the average inventory value. One of the most important words in that formula is "STOCK" from "stock sales". This is where I see the greatest confusion when distributors calculate this metric. They tend to throw all sales in the numerator of the equation. When you include a drop ship into the measurement, are you really measuring the performance of your money? Did you invest your money to hold that item in inventory? Of course not. The inventory was held at the supplier's facility. This logic holds true for non-stock specials that you buy for a customer.
Transfers to fulfill a customer order are often included in the inventory turn calculation for the selling location.
Should they be?

When you are determining the performance of inventory in a certain branch, they should be excluded. Again, we are not using the inventory of the selling branch, we are capitalizing on the assets of the shipping branch. You can see how the numbers can be fairly skewed. This is why I am very skeptical when I see industry averages. How sure are we that the other guy did the math right?

If my compensation was based solely on inventory turns, I could easily achieve the goal. The fastest way to increase inventory turns is to reduce the average inventory value. If you want to reduce inventory, quit cutting purchase orders. Believe me, you would bring that average down in short order. Unfortunately, it would also have severe consequences on your sales figures – but that isn't what we are measuring. Can anyone see the danger?

I am very concerned that distributors may be leaning toward a wholesale slashing of inventory values in order to preserve the cash. Things like buying budgets and buying after the 25th of the month might be coming out of the closet. Folks, these are dangerous practices that focus on short term gains and create long term problems.

If you want to reduce inventory value, take a hard look at the dead and dying inventory. Get rid of the inventory that no one seems to be interested in. Be very cautious when a supplier suggests that you need to carry the whole breadth of the line. Look at your safety stock levels on the least popular items. Breadth of line is ok, but don't allow depth in the less popular items.

As I mentioned earlier, the wholesale reduction of purchase orders will have negative consequences. Without inventory on hand, your customers will see you as an unreliable supplier. This is why we must measure our customer service level in conjunction

The formula for measuring customer service is this: take the number of lines (on customer orders) shipped complete divided by the number of lines ordered. This is a fairly strict measurement of how well we met the customers' needs. If a customer orders 10 grinders and you have 8 in stock. You ship the 8 and back order the other 2. What is the customer service level on this line of the order?
Many would argue that it is 80%. Wrong. It is 0%. You failed to meet request of the customer.
The customer wanted 10 and you gave them 8. If they wanted 8, they would have ordered 8. Think of measuring the customer service performance by the order. For example, if there were 10 lines on a customer order, and we were able to ship 8 of those lines complete, we would achieve an 80% customer service level for that order. Seems a bit harsh, doesn't it?

Let's put this another way. Say you stick your ATM card in the bank machine and request $100. The machine spits out $80 and tells you to come back tomorrow for the other $20. 80% isn't bad, right? You only have to wait a day for the remainder. Are you satisfied with this transaction? I have a feeling that some of you would let your frustration be known to the little camera in the ATM.
Now that we are measuring customer service percentages, what is the goal? We typically like to see our clients shoot for an overall percentage of 90 – 95%. Anything higher than 95% would force us to invest a ridiculous sum of money in our inventory. We probably wouldn't have the space to achieve a 96% or higher. This is an overall inventory percentage. Some items will be higher than 95% and others will be lower than 90%. Here is a great way to use this measurement. Make sure that your most popular items, the top 5% your customers expect you to have, are in the 99-100% range. This will give you the appearance of having everything when they need it. As the popularity drops, the customer service percentage can drop with it.

When you are measuring a vendor line, watch out for an overall service level in the low 80%. This means that you are carrying too little inventory or you may simply be carrying the wrong inventory. Go back and review the hits ranking to see which items are most and least popular. Adjust your levels to get the customer service percentages in line.

Turns and customer service is the balancing act that all inventory managers must face. If we try to spin the inventory too quickly, we will develop holes in stock. Backorders will occur and our customer service will deteriorate. Let it deteriorate too far and the phone will stop ringing. Conversely, when we tip the scales too far toward the customer service side, our turns will reduce and we will be forced to borrow more. One side can not exist independent of the other.

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