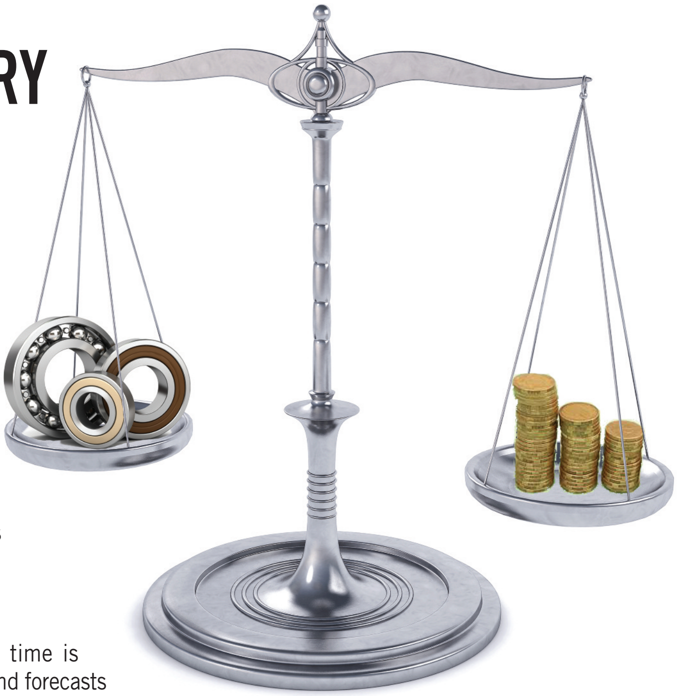
COUNTING THE COST OF INVENTORY



Inventory carrying cost

Most people understand how inventory carrying cost should reflect the full costs of holding stock. It is an important factor in inventory planning calculations when you are trying to optimise the most appropriate inventory levels. It is typically stated as somewhere between 15% and 35% when you properly consider all the contributing components that can include:

- The cost of working capital
- Warehousing, racking, and energy costs for the facilities (you might have primary and even overflow locations)
- Stocktakes
- Shelf lives of perishable products
- Security and shrinkage (such a euphemistic term, I always think)
- Costs of write downs and write-offs (and of course provisions for these need to be far higher for the less popular, higher risk products)

Most businesses are very comfortable with the idea of carrying costs and even that they might be planned for at levels like 20% or even more.

As a benchmark, for a business with a gross margin of 40 percent, achieving four turns per annum and a planned carrying cost of 25 percent, the overall total impact of the carrying cost would be just 4 percent of total revenue. It might sound a bit on the low side (unless you compare it with profitability in which case the number sounds much more significant).

However a focus on carrying cost alone can seriously understate the true costs of managing inventory. It is often more appropriate to consider the cost of <u>not</u> carrying stock.

The Impacts of NOT having stock to carry

Ask what you spend on emergency stock transfers and emergency freight. An emergency stock transfer costs typically four to eight times that of a normal purchase or replenishment. It is not just the cost of the airbag. It is the expense of inefficient picking, packing, shipment and receipting. It is the cost of the time of the staff in the branch who chase the stock or despatch the branch ute to pick it up. It is the loss of time your business incurs when staff do non-value adding activities rather than driving sales and servicing your customers. If you work out the numbers, then it is easy to come up with a percentage point or two of revenue being spent in managing emergencies.

And then of course there are times when you do not have the stock at all and you lose the order. In that case, the impact can be significant financially, but also on your business reputation and strategic position within the market. How much of an impact do the loss of sales have on your gross margin? You took the sales call, you spent the time, and then you could not satisfy the order. You had the expense but nothing to show for it. And it is less likely that person will call again. And all that can easily add up to several more percentage points of revenue.

The 'stuff' that needs to be done

How many people, how much time is spent on managing stock, demand forecasts and supply planning? If you add up the 5-10 percent of time that sales staff spend on doing forecasts, the time they spend chasing supply, and then all the time of the inventory and purchasing managers, and a decent proportion of management's time then what does that all add up to?

Furthermore, how much does the monthly S&OP process cost you? How much time is spent on introducing new products? How much time is spent each month, quarter or at year end reviewing inventory levels? How many people are involved? For all that expense what do you get in return? If you spend $100 to prepare your typical purchase order, how much can you reduce that to if you handle most of the purchasing decisions automatically? Half that?

If however, you look honestly at the total amount of time and effort spent on the key processes that impact on inventory it is very easy to get to 20 percent of your total expense base and that in turn will be another few percentage points off your revenue.

The 'stuff' you don't need

And then let's consider the sleeper in the carrying cost debate – the write-downs and write-offs when you really get it wrong. That can really hurt and you can easily take another couple of percentage points off the bottom line. If you don't manage the excess well, it can affect your access to cheaper funding sources too.

The 'stuff' you ought to be doing

While of course you are spending too much time on activities that sap value from your business, there are a lot of things that miss out on your attention. How much better would it be if you spent more time on working with your suppliers and customers to develop win-win relationships, to help reduce shared costs and strengthen customer loyalty? How can you reduce risk by giving suppliers visibility of your future demand pipeline? What might that repay you when a supplier gets pressured over a short supply situation? Will you be the winner or loser?

Helping do the right stuff

When you add up all the components of cost involved in managing demand, supply and inventory it is very easy to see that your organisation can spend 10-20 percent of revenue across these processes. Relative to your profitability it can be a very big number indeed.

Perhaps it's time to look at each of these areas and ask if is there a better way to manage your inventory. Are the tools you have enabling you to break free from 'administrivia'? Is all the love and care you put into maintaining master data reciprocated by your inventory management system? Does it make most of the right choices for you? Rather than being easy to work with, does it all just represent labour and very little love?

With a long tail of slow movers, many might earn as little as a hundred dollars or so each year, before you account for all the time spent unproductively on each item. Can you shift your time and effort to sales and service, inventory policies and portfolio management? Is the 'stuff' getting on top of you, or are you focused on the right stuff?

For further information consult www.horizoninventory.com.au or email info@horizoninventory.com.au