

Four Strategies for Smarter Inventory Control

Section 01 Synopsis

This paper is provided for companies that carry inventory (manufacturers, distributors, retailers and service providers) and want to better manage their inventory availability while reducing ordering and carrying costs. This paper will present four seemingly simple – but proven – strategies for smarter inventory control.

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Maintain accurate inventory records; expect higher operating costs

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Proactive planning to avoid shortages and overstock situations

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Focus on improvement to get incrementally better over time

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Reduce lead times and lot sizes by reducing the “fixed” ordering costs

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The importance of inventory control and reduction

Section 02

Introduction

Every manufacturer and distributor has inventory, often making up a significant investment and considered a key factor in operating strategy. Because of its value and visibility, inventory is often the focus of cost-cutting efforts and a key measure of company health. When companies invest in software systems for Distribution Management or ERP (Enterprise Resource Planning), the top item on cost justification / return on investment (ROI) analysis is usually inventory reduction.

Does inventory deserve this prominence? Yes, of course it does. Inventory truly represents a large investment of company cash and therefore should be closely managed. More importantly, inventory serves a critical operational function, and that is its role as a substitute for time in being able to satisfy customer demand. In distribution, having inventory in a nearby warehouse allows the distributor to deliver goods to the customer very quickly. In manufacturing, finished goods inventory allows shipment on the same day rather than asking the customer to wait until the item is produced. Raw materials and parts enable the immediate start of production when a make-to-order product is ordered.

It is important to manage such a critical resource to make the most of your company's investment and to assure that the inventory you need is available when you need it. There are only two basic parts of inventory management: knowing what you have, and managing acquisition (replenishment).

Keeping track

Inventory tracking can and should be very simple—it's just a matter of keeping a running count of what comes in and what goes out (and therefore what's left). In modest situations where there are a limited number of items to track and relatively few activities, the inventory balance can be tracked on paper file cards or an Excel spreadsheet.

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More complex and more active situations call for the use of inventory management software that does exactly the same thing—keeps a running count of additions (receipts) and subtractions (issues) and the resulting balance. But inventory management software can do much more, including accurate tracking of multiple quantities of a specific item in multiple locations, tracking lots and serial numbers, recording and enforcing expiration dates and FIFO/LIFO (first-in-first-out, last-in-first-out) picking, inventory valuation, automated data collection, quality control holds, usage analysis and replenishment management, and much more.

Replenishment

The amount of inventory on-hand is the result of receipts (inventory coming in) and issues (inventory going out). Inventory goes out in response to demand—customer orders, inter-warehouse orders, pulling parts to support production—all activities that are placed on the warehouse from outside (customers, other warehouses, or the plant). The inventory manager controls replenishment (receipts).

In simpler situations, replenishment can be managed through some form of “order point” management, either formal or informal. Order point can be as simple and informal as walking through the warehouse or stockroom from time to time and looking for empty spaces or bins with smaller than usual quantities. Another approach is called “two-bin order point” Where the items are stored in two containers: one is used as the main supply and the other is in reserve. When the main supply is exhausted, the reserve supply is moved up to the main supply position and the empty container serves as the re-order signal. As long as the replenishment is completed before the reserve (now main supply) is used up, you won’t run out. Two-bin order point is actually a primitive form of kanban (a common inventory control technique that uses physical tags or containers to trigger replenishment).

Order point can also be computerized and is embedded in many inventory management software products. Computerized order point uses material usage statistics and replenishment lead times to calculate the best order

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point and replenishment recommendations for each item, or it can work with manually entered reorder points and safety stock requirements to recommend replenishment orders.

Inventory management benefits

Knowing how much inventory you have and managing replenishment are fundamental requirements for having the inventory you need to satisfy customers and avoid disruption caused by shortages. Without good information and controls, you will likely have more inventory than you really need and still suffer from unnecessary shortages. Good inventory management pays off in higher customer service and satisfaction, lower overall inventory investment, fewer backorders and lost business, reduced disruption and lower cost of expediting.

Maintain accurate inventory records

Section 03

Strategy #1

The accuracy of any inventory tracking system, whether manual, spreadsheet or software depends on timely and accurate transaction reporting.

It is difficult, if not impossible, to effectively manage inventory without an accurate record of what you have. You make promises to your customers (accept orders and quote ship dates) based on what you know is in stock. If the reality is different from the records, you may not be able to keep those promises, resulting in disappointed customers and lost business.

The accuracy of any inventory tracking system, whether manual, spreadsheet or software depends on timely and accurate transaction reporting. Any inventory movement must be reported to the tracking system promptly and accurately.

While this is a simple requirement, it is not necessarily easy. Any human-based procedure is subject to error, delays, lost transactions, bad math, and misidentification. Timely and accurate transactions only occur when the people reporting the transactions understand the importance and are properly motivated to do a good job. There's no magic here, it all depends on motivation and management.

For example, if an employee is moving items to put together a customer order, their primary focus is on getting the right things into the box and doing it quickly. Your challenge is to find a way to make it important to also report what was picked, from what location, identifying information (lot or serial number, if needed), or whatever else you need to track.

Some data collection can be automated, most often through bar-code scans. Most inventory software will produce bar-coded lists and labels, interface with scanners, and manage the data collection effort. Not only is automated data collection more timely (data goes right into the inventory records, doesn't have to be keyed in), but it also eliminates a lot of the sources of error that are part of manual data collection.

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Strategy #1
Maintain Accurate
Inventory Records

Whether automated, manual or a combination of both, inventory records are error-prone. You might complete an annual physical count and learn that your records are only a few percent off, but that is a false measurement. It is likely that as many as half of your inventory balances are inaccurate but the physical count only looks at total value and the plusses and minuses balance each other out to give you a misleading total difference.

A much more telling measure of accuracy is to count 100 items and see how many are correct and how many are not. Most companies are shocked to learn that, by this measure, accuracy is less than 50%. The solution is to implement the cycle counting process to improve accuracy by eliminating the cause of errors, which are part of the transaction reporting process.

Cycle counting involves a process of counting a certain number of items every day or week such that groups of items 'cycle' through the counting scheme so that they are all counted according to their importance--more important items are counted more frequently. Specifics for setting up and running cycle counting are available from your inventory software support staff, from a web search, or from operations-focused organizations like APICS. The benefit of cycle counting is that it allows you to identify how errors occur and fix the faulty procedures so errors are eliminated. In this way, accuracy improves and can be maintained at a high level (>98%) even in an organization with thousands of items and many daily transactions.

Proactive planning

Section 04

Strategy #2

Inventory management, planning, and optimization systems offer a wide array of tools that allow you to be proactive in managing inventory in the plant, the warehouse and throughout the supply chain.

Replenishment describes the process where inventory is brought into the warehouse to replace inventory which is used or sold. The most efficient replenishment will plan for the new supply to arrive just before it is needed, in other words, just before the supply runs out (just in time). Order point (mentioned above) does that based on average or assumed usage and typical lead time, but there are other approaches.

Manufacturers use an approach called Material Requirements Planning (MRP) that calculates how much of each material and component items is needed, and when, to be able to complete the master production schedule. Distributors can use a similar technique called Distribution Requirement Planning (DRP). Both techniques are based on a forecast of demand (sales), and work backward in time through the distribution network (DRP) or bill of materials (MRP) to line up replenishment orders (quantities and start dates/due dates) to minimize inventory while preventing shortages. Both approaches rely on accurate data (inventory record accuracy included) and good forecasts.

There are other approaches that some companies find more beneficial for their particular markets, but the point is that while inventory is costly, shortages can be devastating to the business. Simple management approaches like order point may not deliver the combination of low inventory and high availability that you need. Inventory management, planning, and optimization systems offer a wide array of tools that allow you to be proactive in managing inventory in the plant, the warehouse and throughout the supply chain.

No replenishment planning approach is perfect—because we cannot know the future (demand) exactly, and because demand will vary from day-to-day and week-to-week. In order to protect the availability from

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Strategy #2
Proactive Planning

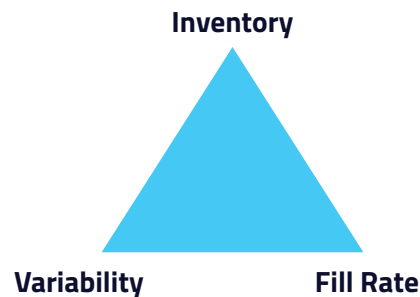
these variations, companies carry a little extra inventory, called safety stock. More safety stock will reduce the risk of a “stock-out”, of course, but more safety stock also adds to your inventory investment. The same holds true for other safety measures like shrinkage factor, yield allowance, padded lead times (telling the supplier to deliver before you expect to need the items just in case they deliver late)—they all add inventory.

Focus on improvement

Section 05

Strategy #3

With any inventory planning and control strategy, the objective is to avoid shortages while minimizing the amount of inventory. The easy way to reduce or avoid shortages is to have more inventory. Reducing inventory is likely to increase the risk of shortages. There is a way to change this relationship because there is a third factor involved—and that is variability. As mentioned at the end of the previous section, safety stock is the customary way to compensate for variation including swings in demand (otherwise known as forecast error) and other unexpected changes in demand or supply (including inventory accuracy errors).



Since the future is unknown, it is impossible to cover all possible variation. We are left to cover the majority of the expected problems and live with a level of availability (fill rate) less than 100%. The more safety stock, the higher the fill rate.

If you can reduce variability, however, you can increase fill rate without increasing inventory. Alternatively, reducing variability would allow you to reduce inventory (safety stock) without reducing fill rate. Simply put, to reduce inventory while maintaining or improving fill rate, reduce variation.

Section 05:
Strategy #3
Focus on
Improvement

How can you reduce variation? The most obvious ways are:

- Improve inventory accuracy (use cycle counting)
- Improve forecast accuracy (collaborate with customers, distributors)
- Reduce lead time (improves forecast accuracy, see below)
- Become more reliable (tighten up procedures and controls)
- Consider implementing integrated systems like ERP, warehouse management systems, automated data collection and other technologies that will improve accuracy

Reduce lead times and lot sizes

Section 06

Strategy #4

With shorter lead time, replenishment quantities can be smaller, meaning that less inventory is brought in at a time and used up more quickly.

If lead time was zero, you wouldn't need inventory. The longer the lead time, the more inventory you'll need, and the more safety stock because variability is a time-sensitive phenomenon. There is more risk of variation over the course of a week than there is over one day. Forecasts are also more accurate in the near term than they are further out. Replenishment planning is focused on replenishment lead time. With shorter lead time, replenishment quantities can be smaller, meaning that less inventory is brought in at a time and used up more quickly—so overall inventory level is reduced.

Replenishment lot size is usually determined through the general concept of economic order quantity or EOQ. EOQ balances ordering costs (fixed costs associated with purchasing or making an item regardless of quantity) and carrying cost (larger order quantity means higher inventory and therefore higher carrying cost). EOQ finds the lowest cost replenishment order quantity.

While many companies do not use the actual EOQ formula to determine lot size, the concept still holds in informal logic and intuitive methods—a successful business minimizes overall cost by avoiding unnecessary inventory and minimizing the number of orders at the same time.

The key to reducing the “economic” replenishment order size (thereby reducing inventory) is to reduce the fixed ordering cost (there isn't a lot you can do to reduce carrying cost, unit cost or usage—the other major factors). For purchased items, ordering cost includes the operating cost and efficiency of the purchasing department, receiving and inspection, and material handling (put-away).

Section 06:
Strategy #4
Reduce Lead Times
and Lot Sizes

Integrated purchasing applications with supplier portals for collaboration, links to planning systems for automated or semi-automated ordering, blanket orders (based on good forecast-based plans), electronic communications (through EDI or direct), and other technologies can help ease the ordering process. Pre-qualified suppliers and certified quality simplify and expedite receiving and handling.

For manufactured items, the focus is on set-up and changeover times. Companies often invest in automation--flexible machines that can easily switch from one product or variant to another with little or no human intervention—to reduce changeover and thus reduce economic production quantity. Other less costly changes include fixturing and mistake-proofing (also known as “poka-yoke”), scheduling to minimize the changes between one job and the next, and process redesign to simplify changeover.

Section 07

Summary

Simple but proven strategies for smarter inventory control

Inventory is a major investment for most companies and lower inventory is often an important management objective. Simply lowering inventory without a plan, however, is likely to increase the incidence of shortages, expediting, disappointed customers and lost business.

There are smart ways to reduce inventory that won't increase the risk of shortages.

To manage (and reduce) inventory, one basic requirement is to know what you have. A good inventory tracking system does not have to be sophisticated or expensive. More than anything else, it takes discipline in reporting activities (transactions) in a timely and accurate manner. Software can help with inventory tracking and add many tools for measuring and improving accuracy.

Inventory control, and the ability to reduce inventory to the amount needed to assure desired availability, depends on effective replenishment planning. There are a number of approaches for triggering and managing replenishment and there is software available to help, ranging from simple order-point systems embedded in basic inventory software to fully integrated enterprise-wide software suites (Enterprise Resource Planning) for manufacturers, distributors, and service providers who also have an inventory component.

Even with good software and processes in place, the level of inventory is always dictated to some extent by the amount of variability that exists. Variability refers to the unknowns, including demand that doesn't exactly match the forecast and varies from day-to-day even within the forecast; surprises of all sorts including late deliveries from suppliers, inaccurate records, late schedule changes, equipment breakdowns; and much more.

You don't have to simply accept the level of inventory you have. By understanding the reasons why you have inventory and addressing the underlying causes, you can reduce inventory without raising the risk of shortages.

Section 07:

Summary

Simple but Proven
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Control

We customarily add extra inventory (safety stock) to compensate for this variability. The more variability, the more inventory is required to maintain service levels (fill rate). Because of this, a good improvement strategy focuses on reducing variability through more accurate record-keeping, better forecasting, reducing lead times, and adding procedural discipline.

Inventory can be considered a “necessary evil”, but you don’t have to simply accept the level of inventory you have. By understanding the reasons why you have inventory and addressing the underlying causes, you can reduce inventory without raising the risk of shortages—a true win-win for operations managers, the company, and your customers.