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Reducing inventory while preparing recovery April 2020

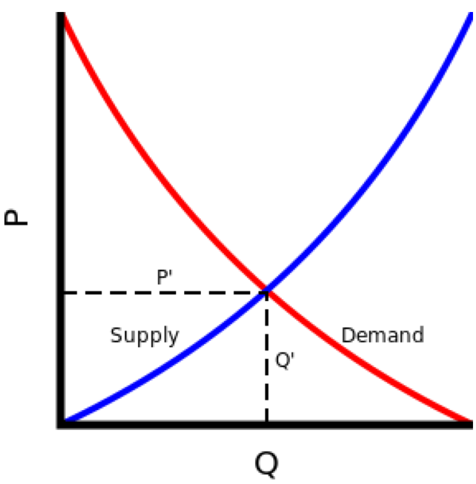
Have the right stuff at the right time

Cash is on the mind of Finance leaders more than usual these days. And as the economies of the world are placed into what FT.com calls an induced coma, business leaders must make difficult choices about many things including these often-repeated questions; “How do I know I am cutting the right inventories?” and “Will we have what we need to start the business back up again?” Unlike the incalculable human cost of some decisions companies are being forced to make now, inventory cost can and should be calculated. It is daily work of supply chain professionals to perform those calculations and to give accurate numbers to their business leaders so they can make the difficult decisions with the best information available. Here are a few things to look for in your business that help determine if your inventory analysis is good enough.

1: Identify critical products

Every manufacturing company purchases critical and less critical products and services. To prevent internal competition between programs or product lines, the criteria and process of evaluating criticality should be as unbiased as possible and should be owned by Supply Chain or Procurement. Revenue impact, difficulty of sourcing and lead time are all factors in determining criticality and a scoring mechanism should be devised to reduce the impact of emotional decision making. One industrial equipment manufacturer baked the process for identifying critical items into their S&OP cycle. First, Sales and Marketing provide a forecast of product sales (not only revenue) for the coming year. Next, Planning compares the BoMs for those products to find the most used part numbers and ranks them by average lead time weighted by spend. The list is then reviewed by procurement who rank the parts based on sourcing difficulty. Finally, Operations provides a ranking based on ease of manufacture and set-up time. The cumulative score represents the criticality of each part number by supplier and is an input into inventory management decisions and risk mitigation strategies. Other companies may use revenue impact or supplier financial risk as determining factors as well, but whatever the criteria you chose, the process must be cross-functional, repeatable and as objective as possible.

2: Let demand patterns drive stocking policies



Inventory segmentation by usage value and demand pattern is required to determine the appropriate stocking policy for inventory items. Understanding the stock drivers and the patterns of demand is a critical first step when assuring we will have supply of products we need when things start moving again. To improve working capital a company must hold fewer high-value items, but if those items have a long lead-time for replenishment, reducing stock increases risk. So, we need a differentiated stocking strategy driven by real demand. For instance, if demand patterns indicate high variability (excluding exceptional events) we may want to ask for a supplier to hold some inventory for us rather than holding that stock ourselves. But first we must have completed a stock analysis that shows us our usage patterns. One plant manager at a multi-billion-dollar business was making his monthly inventory report. He took a piece of paper and walked around the plant writing notes about how much material should be ordered for the next month, which he then handed to the buyer. He was an experienced manager with knowledge of his business, but there was no quantitative analysis to use to communicate demand and the business lacked the skills to provide it. Unsurprisingly, stocks in the business were out of control, with buyers purchasing huge quantities of rarely used product in order to hit ppv (Purchase Price Variance) cost reduction targets while commonly used product was expedited from suppliers at a premium to cover potential shortages. Many small and medium sized enterprises operate in a similar fashion. Understanding demand patterns and appropriately adjusting replenishment methods to support those patterns will improve customer service while reducing inventory, total cost, and risk.

3: Manage “C” items

Acquiring low value items should not distract Procurement and Supply Chain teams when they should be focusing on meeting customer demand. We need them to be free to spend their time adjusting the schedule or supplier requirements for critical stocks rather than expediting low value items to keep production running. At one plant that produces heavy dual-axle trucks used to pull trailers, a dozen trucks would be sitting at the end of the production line waiting for a low value part on any given day, i.e. a battery cover or mud flaps. To assure that the product moved before the end of the month (reducing the inventory reported) planners and buyers spent the last week of each month expediting these specific, low value parts instead of concentrating on planning and scheduling high value, hard to predict product deliveries. Although their activity reduced reported working capital it would have been unnecessary if low value parts had been managed more efficiently. Letting suppliers manage stock levels of C items or simply holding enough stock of those items to keep shortages from demanding the attention of Supply Chain is better for working capital in the long run.

4: Use one playbook

Finance, Procurement, Supply Chain, Operations and Business Development must all be working toward the same goals. Especially in times of crisis, organizational planning, including S&OP processes and Integrated Business Planning systems, need to be functioning better than ever. A Canadian based manufacturer of industrial robots was having trouble with customer service from one of its plants in Europe. When the new plant manager came on board he decided to tackle the problem. He took the Sales Director out for dinner and the two of them discussed the fact that operations and sales did not trust each other. Sales would inflate demand from customers because they didn’t trust operations to provide what they forecasted. And operations, suspecting the demand communicated from sales was too high, would routinely adjust production schedules based on their own forecast ignoring the numbers that came from sales. The Sales Director and Plant Manager decided to start a “Tell the Truth” campaign where sales agreed to forecast true demand and operations produced to the sales forecast. Customer service increased by 20% and inventories fell by 40% within 6 months. In times of uncertainty we need our suppliers to be ready to move with us. If we expect suppliers to be honest about their capabilities and capacities, we must model open honest communication inside our own business and create a culture of transparency. Then we can approach our suppliers with a plan that is as stable as possible so they can plan their business wisely and they will be there for us when we need them.

5: Manage relationships with key suppliers

Supplier relationships impact inventory. Our inventories are sometimes determined by their stocking policies and working capital needs. Their set-up cost and order costs influence the minimum order quantities they require but so does our relationship. The way suppliers view our organization impacts their decisions about how and when to take on the risk of holding stock for us and whether they devote resources to developing flexibility we may require in the future. We have to sell ourselves as partners to our key suppliers, asking questions about their business goals and aligning our success with theirs. But first we must know what those goals are. We should spend time and effort to determine the attitude our key suppliers have toward us and their goals for working with us in the future. The better we know our key suppliers, the better able we are to meet their needs as well as our own goals, while reducing cost and inventory across the value chain.

6: Know who has responsibility for inventory

It is important to assign the responsibility for inventory management and measure performance. The best results are achieved when inventory targets are owned by operations leaders and not only by Finance. Focusing on controlling inventory can be a competitive advantage in times of crisis because inventory focus improves customer service, reduces waste and optimizes working capital. Companies that say that “everyone has responsibility for inventory” usually do not hold anyone accountable for inventory levels that are too high. These companies routinely keep working capital tied up in inventories that are unnecessary and do not have the free cash flow to operate with as much flexibility as their competitors.

Conclusion

When these six elements are managed correctly in your business you can trust that your inventory analysis is sound, and you will be confident you are holding the right stock to position your business for recovery. The technology used to complete the analysis, accuracy and cleanliness of the data and expertise of the analysts also are important, but these technical requirements vary by industry and market. And while good systems and processes will help to provide good data, giving business leaders the information they need; Identifying critical products, Setting stocking policies based on demand pattern, Managing “C” items, Using one playbook, Managing supplier relationships, and Holding people accountable for inventory often have a bigger influence on real inventory requirements. And managing these elements better than competitors improves your flexibility, which reduces risk and improves our ability to meet customer demand.

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Website: www.informita.com

Twitter/Facebook: @informita

Email: info@informita.com
Phone: +351-911556662
+1-928-273-0127