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Myths, Legends & Old Wives' Tales... Slaying the Inventory Dragon

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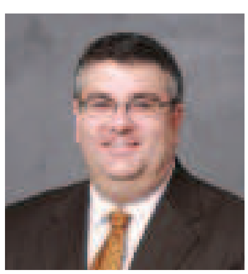
Often the first signs of a company's distress are not seen in the board room, but the warehouse, where too much of the wrong stock builds up to crisis levels. This article describes some of the most persistent myths that muddle the world of inventory, how they damage a business and how a few hard facts can unleash a lot of value.

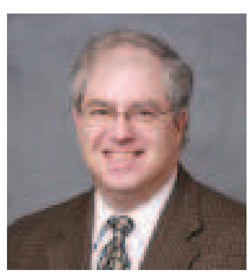
The business world is full of myths. They may not be as astounding as the gods and monsters of Greek or Roman lore or any of the many other great bodies of world mythology, but there are persistent stories and rules of thumb that shape business thinking and impact bottom line results. There are few topics more muddled by myths, legends and old wives' tales than inventory.

Over the course of many years of working with both healthy and troubled companies, we consistently see clients, from CEOs to front line managers, with critical issues caused by believing some of the more questionable inventory myths. Often the first signs of a company's distress are not seen in the board room, but the warehouse, where too much of the wrong stock builds up to crisis levels. This article describes some of the most persistent myths that muddle the world of inventory, how they damage a business and how a few hard facts can unleash a lot of value.

Myth #1: Overproduction — "Higher Volume Spreads My Fixed Costs"

The logic is very simple, but completely flawed: fixed costs are spread over the volume produced, so more volume supposedly drives costs down. This faulty thinking is exacerbated by a typical production mindset of "never stop — keep the machines running," and incentives based on average cost or production quotas. This only results in a build-up of excess inventory, exposing the company to a variety of unexpected costs, including storage and obsolescence, while tying up working capital. Rework may be required if customer requirements change or different product configurations are needed; worse still, if demand changes, companies may be left unable to sell without slashing prices.





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Myth #2: Over Purchasing — "It's Cheaper By the Dozen"

A similar mindset drives purchasing. Bulk discounts may look attractive, but they drive a lot of unattractive behavior down the rest of the supply chain. The raw materials will be subject to the same unexpected costs of storage and obsolescence. When faced with long lead times from overseas suppliers, purchasing managers respond by keeping months of stock on hand, rather than scheduling small orders in quick succession.

Myth #3: Poor Planning — "Just Forecast a Little Better"

As the strain of extra inventory starts to tell, the first reaction is to try and predict customer demand "better." While efforts at accurate forecasting are worthwhile, they will never be the complete solution to an inventory issue. Demand is unpredictable. No amount of analysis or sophisticated software will solve that. The key is to create an organization that is flexible enough to respond to the changes in demand.

Myth #4: Financing — "Inventory = Assets = Good"

Assets are good, right? A larger inventory means more assets, means collateral to borrow against — correct? This rationale does not last long. Once stock is built up, it is often extremely difficult to clear out the excess. The balance sheet becomes clogged with excess inventory, and subsequently, working capital is tied up. Eventually, write-downs may be unavoidable, and if borrowing against the inventory has occurred, the finance department will be reluctant to admit to lenders that the value of their collateral has fallen.

Myth #5: Cautious Sales — "We Must Have Six Months of Safety Stock"

Safety stock, the extra inventory kept to avoid stock-outs, is another cause of inventory proliferation. Sales managers tend to over-forecast to avoid the pain of running out and a potential impact on a sales relationship. Variability in production makes the problem worse, so safety stock levels will be even higher if supply is unreliable. Additionally, excessive safety stock can create a false sense of security all the way up the supply chain, and forestall a company's efforts to improve efficiency.

Myth #6: Unnecessary Customization — "But I Need it in Salmon Pink"

Customizing products may increase the effectiveness of sales and marketing, but can substantially increase supply chain complexity. Offering large numbers of SKUs (stock-keeping units) can often lead to having too many of one item, and suffering stock-outs in others, or having to undertake costly rework to adapt old stock to new demands. Salespeople will usually push for a larger range of SKUs to meet customers' requests, even if they provide minimal real value to the customer. Push salespeople to talk with customers about what their true priorities are and how these can be met with a manageable number of SKUs.

All these myths add up to a dangerous trend: inventory increasing unchecked until it is inhibiting operations, tying up funds and increasing costs. Too often, companies try to deal with an inventory problem by across-the-board cuts in purchasing, which means that high-demand, fast-moving items are often out of stock.

A Dose of LeanSigma Reality

LeanSigma principles of process improvement provide a very real solution for management teams taken in by mythology surrounding inventory. LeanSigma's ultimate objective is to eliminate any effort that does not provide value, and it provides a holistic overview of any process, including back-office activities, to make it streamlined and flexible, dramatically cutting both excess inventory and associated costs. Here's how:

- ***Change fixed costs into variable ones.*** Since fixed costs are often at the center of an inventory issue, determining whether costs are genuinely fixed can root out overproduction. Renegotiating supply and labor contracts, reviewing leases for facilities and equipment and scrutinizing large scale investments can all help keep overhead costs variable.

  Example: A paper manufacturer responded to high fixed costs by producing to maximum capacity and selling the extra output to low and negative margin customers. The result was negative EBITDA when it was operating at the maximum capacity of 10,000 tons per month. By shifting "perceived fixed" costs into variable ones, and no longer serving low margin customers, they were able to generate positive EBITDA, even though volume was reduced to 7,000 tons per month.

- ***Reduce cycle times.*** The longer your cycle time (time from raw materials to finished goods), the further out you need to be able to forecast. By cutting time to fill orders, you can be more responsive to customers, carry less raw material and finished goods inventory, and reduce the risk of faulty forecasting. Focus on wasted time such as transport, unnecessary processing and waiting. Attack rework and defects requiring repair. Quick cycle times will mean agile, fast production that does not need the costly baggage of excess inventory.

  Example: From start to finish, it took a kitchen cabinet manufacturer five weeks to produce a cabinet because work in progress (WIP) inventory spent so long waiting at each stage of manufacturing. Since clients demanded that orders be filled in a far shorter time, the company had to maintain costly levels of safety stock to respond. By focusing on keeping the production line flowing and minimizing wait times, the company reduced the cycle time from five weeks to two weeks, allowing it to respond more quickly to customer demand, and fill orders precisely with minimal risk of extra costs or obsolete inventory.

- ***Smaller batches, more often.*** Either from habit or efforts to rationalize shipping costs, purchase orders are often larger than they need to be. Make orders as small and as regular as economically possible. Track inventory "on the water" as if it was just another warehouse to keep stock levels low in more costly storage areas.

  The same applies to production. Batches become too big when managers try to amortize costly setup time over the maxim number of units. Instead of increasing volume, focus on shorter setups by eliminating wasted time and preparing for changeovers while the production lines are still running. Smaller batches mean less overproduction, less WIP inventory and a more agile operation.

  Example: Faced with six-week lead times to deliver from Asia, a household goods importer made large orders every few months to get all the stock it needed. By moving to smaller weekly orders, the company was able to dramatically reduce inventory in its warehouses. Also, by focusing on setup times, the same company cut the time to set up a production line from three hours to 45 minutes, saving cost and increasing flexibility.

- ***Establish balanced metrics.*** Production incentives often target average costs and on-time delivery, and may ignore inventory turns and other working capital measures. Consequently, some employees may knowingly overproduce, to the detriment of the balance sheet and the company's long-term finances. To avoid extreme behavior, construct incentives that are balanced. For example, establish both inventory turns and on time delivery as metrics. Rather than just focusing on production, employees will be driven to find innovative ways to meet customer expectations while keeping inventory as lean as possible.

The Scariest Myth of All

All across your company, inventory myths, hard and soft incentives, rules of thumb and lazy thinking drive up inventory. Getting rid of excess and obsolete stock is painful, and only gets more difficult as inventory spins out of control. The resulting negative cycle clogs up your supply chain and your balance sheet. If you cannot find vital inventory among the piles of obsolete stock, it's time to address the issue, before you are lying awake hoping for a mythical hero to save you from the very real monster in the warehouse. abfj

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