



10 questions to diagnose your inventory health

CFOs and other senior executives already know the importance of inventory management. And yet even the most attentive managers often find it difficult to get it right. In our work with clients, we've found that decision makers often rely on external benchmarks that seldom deliver expected insights. And they make operating assumptions that send them down the wrong path. Two of the classic misconceptions: improving the accuracy of sales forecasts is the best way to reduce inventory and beefing up customer service requires keeping more inventory on hand. The fact is, both assumptions can lead to inventory gluts or shortages.

As most executives know, getting the right levels is vital since it not only controls costs but also serves as a barometer of a company's overall health. We've found that best in class supply organizations are able to improve inventory levels by between 20 percent and 50 percent by employing sophisticated analytical tools, resulting in savings for years.

We typically ask clients 10 questions that take the pulse of a company's inventory health. They are designed to assess the effectiveness of inventory reduction processes as well as the sophistication and breadth of those efforts.

Taking an Inventory Pulse Check

1) Are you able to break down your operating inventory into the three major categories when reporting levels—safety, replenishment and excess or obsolete stock?

This breakdown makes it easier to make sound decisions about appropriate levels for each of these three areas. It helps determine the minimum safety stock needed to provide an insurance policy against supply chain problems either from manufacturing glitches or distribution uncertainties so that customers get what they ordered. It's useful for pinpointing the amount of inventory required to replenish deliveries every two weeks. And it helps companies find ways to avoid a backlog of excess or obsolete inventory.

2) Is your company using the most effective method to calculate your safety stock levels?

- Are you using statistical formulas that incorporate the accuracy of sales forecasts, required production lead times, manufacturing schedule adherence and service-level data for each SKU?
- Or are you using a simple rule of thumb such as "all products made in factory ABC need 15 days of safety stock."

The problem with the rule-of-thumb approach is that typically it's based on products with the most uncertain delivery histories. Efficient operations use a standard statistical formula that looks at historical data for individual products.

3) Do you recalculate safety stock levels on a regular basis to ensure they are up to date?

Supply-savvy operations update their calculations about every three to six months to ensure that decisions are based on the most accurate information.

4) Who decides key inventory-related policy such as striking the right balance between customer service and cost-effective product inventory levels?

Many decisions about inventory levels are strategically important. So instead of relying solely on the supply organization to decide, executives need to have a major say in the fundamental issues that impact inventory management—everything from determining the right breadth and complexity of product offerings to optimal plant and distribution footprints.

5) Who determines the optimal frequency for producing or ordering products?

- A cross-functional team or
- Only production planning or sourcing managers?

Several factors impact effective inventory planning. For example, marketing campaigns can play a role alongside sourcing. So a cross-functional team should set production and ordering schedules. Production alone determines lot sizes, usually based solely on minimizing production costs. By weighing all factors and using a sales and operations planning process (S&OP), cross-functional teams often reduce the company's replenishment stock by 50 percent and ensure that the right products are available for big promotions.

6) How do you determine the frequency for ordering and inventory production if it's not set solely by factories or the supply organization?

Ideally, there are two factors: companies should consider calculations that minimize the overall cost such as inventory and changeover costs. They also should base frequency on negotiations between the different parties involved and factor in upcoming events such as promotions and uncertainties like bad weather.

7) Is the optimal order or production frequency calculated on a regular basis as part of a continuous improvement process?

Once you've reduced inventories, you'll have to put new processes in place to lower them even more over time. We use an analytical tool that highlights the biggest levers for continually reducing inventory. For example, instead of working to improve sales forecast accuracy from 70 percent to just 75 percent, establishing a team that's focused on reducing lead times from Asian suppliers may have more impact.

8) Do you have regular visibility into excess and obsolete stock, and is it linked to targeted action plans to sell off or reduce this inventory?

Typically, excess and obsolete stock stems from ineffective sales forecasting, planning or using a business model that fails to factor in product complexity and life cycles correctly. Inventory leaders establish processes to determine why excesses are being created and then develop a plan of action to sell it off. In some instances, the fear of the write-off has led to a large buildup over time of obsolete inventory.

9) Do you perform root-cause analyses on excess and obsolete stock and know how they are linked to action plans that curb more excesses from being created?

Companies with efficient inventory management create two task forces with linked action plans. The first task force identifies the root causes and determines ways to reduce the creation of new excess and obsolete stock. The second focuses on ways to sell off the stock more effectively. It provides the sales team with a list of top excess or obsolete products to push to ensure that they're discounting specified excess products.

10) Do you apply the above practices to all parts of your inventory (finished goods, raw material, works in process and spare parts) and in all organizational entities?

One of the most common mistakes made by supply organizations is looking at only a small subset of all inventory—the finished goods sitting in major warehouses—even though raw materials, works in process, spare parts and even goods in retail stores can make up 50 percent of the total. As a result, they miss potential savings. An organizational map of all inventories will help better prioritize ways to reduce inventories. And all the inventory techniques we've discussed apply.

After answering all 10 questions, right or wrong, the diagnosis of your inventory health sets your company up for significant opportunities to improve expense and asset effectiveness and creates potential for capturing missed top-line sales. Often ignored, inventory pulse checks can be a huge lever to improve the financial health of a company.

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