EMERGENT PARTNERS

MANAGING INVENTORY & PROCUREMENT

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For companies that have to carry inventory, regardless of their size or industry, how those companies manage and acquire inventory either creates tremendous opportunity or presents significant risk.

Proper procurement processes and inventory management create operational efficiencies, improve how a company is able to deliver its products and services to the market, and reduce costs associated with product and service delivery. Consequently, poor procurement processes and improper inventory management can present significant challenges to the growth and sustainability of a company even during highly favorable business climates.

Important also is the procurement and management of non-inventory items that are essential to the operation of the business. Behind the scenes, these items can have a significant positive or negative effect on costs associated with delivering products and services and can also have an impact overhead spend.

So what are the basics of managing inventory and procurement and how can small, privately-held companies implement strategy, processes, and systems on limited budgets to compete in ever-changing markets?

THE BASICS OF INVENTORY

Understanding the basics of inventory is the first step towards developing a strategy on how to effectively manage it.

What is Inventory Management?

Inventory management is the overseeing and controlling of the ordering, storage, and use of raw materials and components that a company will use in the production of the items it will sell as well as the overseeing and controlling of quantities of finished products for sale. A business's inventory is one of its major assets and represents an investment that is tied up until the item is sold or used in the production of an item that is sold. It costs money to store, track, and insure inventory. Inventories that are mismanaged can create significant financial problems for a business, whether the mismanagement results in excess inventory or inventory shortage.

There are several inventory management strategies that can be used to manage your inventory such as Just-In-Time (JIT), Materials Requirement Planning (MRP), Vendor Managed Inventory (VMI), Kanban, and Consignment. Depending on its individual situation, a company may want to use a combination of these methods to manage their inventory levels and reduce their financial outlay.

The procurement of items for inventory that is used directly in the production of a product or delivery of a service is called direct procurement. Inventory management strategy serves as the foundation for the methodology that a company uses for direct procurement. Taking the time to understand how items flow in and out of inventory is important in developing good inventory management and direct procurement processes and strategies.

Inventory Cost

The carrying cost of an inventory is all costs associated with actively possessing inventory items and is usually represented as a percentage of the inventory value. These costs include taxes, employee costs, depreciation, insurance, costs associated with keeping items in storage, opportunity cost, the cost of insuring and replacing items, and the cost of capital that helps produce income for a business. True inventory cost is not just what was paid for the materials or items initially. Understanding, tracking, and managing these additional costs is important because in certain situations they can represent a significant percentage of overall cost and mean the difference between a company being profitable or not.

Physical Inventory and Cycle Counting

Regardless of the size of the business, regular physical inventory counts and cycle counting are critical to inventory management and make for a healthy bottom line. Weekly cycle counts and quarterly, bi-annual, or annual physical inventory counts ensure inventory is correct thereby helping to identify problems that would adversely affect things such as the ability to place future purchase orders or on-time delivery of sales orders to a customer.

When weekly cycle counting occurs most people can recall what happened with the movement of the material the week prior. Were the transactions not correctly made to move the inventory? Was the material not used and put back and the transactions not made to account for the movement? Was another item used in error? Determining the cause of a variance early can make the difference in being able to quickly resolve an issue or creating costly, long-term problems that are not easy to fix.

Physical inventory counts can be tedious, but they are critical in making sure that the cycle count system is working accurately. They also give the business the opportunity to address any larger challenges or discrepancies on a periodic basis. A good process for physical inventory counts provides many benefits including to help ensure inventory is available when it is needed and that there are no accounting or reporting errors that carry over to new periods.

The frequency of the physical inventory counts depends on accuracy of the cycle counts and size of the inventory. If there are too many variances and the size of those variances are large when beginning cycle counting, monthly or quarterly physical inventory counts may be required to determine and resolve the root cause. As the cycle counts improve, the frequency of the physical inventory can be changed. Ultimately, the strategy involving physical inventory counts depends on the business, how quickly its inventory turns, available resources, and margin for error.

Excess Inventory

What does a company do with excess or obsolete inventory? A company should consider the following questions to make that determination.

What is excess and what is obsolete? The general rule is that obsolete inventory is any item that has not been used in 1 to 2 years.

Has a reserve been created for these items determined in excess or obsolete? A reserve account is a "fund" set aside to allow the write off of obsolete inventory at an appropriate time.

Can the excess inventory be sold back to the vendor? Vendors may have other customers who use the same material or be able to find other uses for certain items.

Can the excess be sold for scrap? Is there a legitimate scrap market to sell your excess? Companies can come up with some creative solutions to selling items for scrap such as having the sales department hold some sort of auction to customers who purchase and/or use scrap material.

If the material is obsolete, are there any warranty obligations that can and will use the obsolete goods?

Are there potential sales to be realized if the obsolete goods are stored for a certain amount of time?

Excess inventory that is not managed and grows over time can cause significant cash problems since it is comprised of items that have already been paid for, yet they are not slated to generate income for the company.

MRO (Maintenance, Repair, and Operations) Spend

Understanding MRO items is important because they can significantly impact the bottom line of any company adversely if not managed and accounted for correctly.

MRO items are supplies consumed in the production process which do not either become part of the end product or are not central to the company's output. MRO items can include consumables (such as cleaning supplies or office supplies including coffee, tea, toilet paper, copy paper, etc.), maintenance supplies (repair tools, gaskets, lubricants, rags, etc.), industrial equipment not considered an asset (such as compressors, pumps, valve, etc.), and other items such as computers, fixtures, and furniture.

Companies continuously face challenges in finding creative methods and processes to help improve the efficiency and reliability of their facilities and operations. A significant part of this is finding innovative ways to increase total uptime and improve value-generating capabilities for MRO items.

PROCUREMENT

There are two general categories that procurement falls under, direct procurement and indirect procurement. Understanding the differences between each and how they apply to an organization allows for effective pairings with inventory management strategy.

Direct Procurement

Direct procurement is defined as the procurement or purchasing of raw materials or goods for production. This is where inventory management strategy and purchasing methodology come together. Purchasing methodology such as what items are purchased, when they are purchased, and in what quantities they are purchased is determined by the inventory management strategy. However, there are certain tools in the form of process and culture that must be in place to ensure purchasing methodology is effective.

Systems play a large part in making purchasing methodology effective. Software tools that range from sophisticated ERP systems to simple spreadsheets provide valuable information to the purchasing function. The type of software depends on the company, how it operates, and the industry it is in. However, the complexity of any software tool should match the complexity of the processes and methodologies it is required to support in order to be effective.

Communication is key, especially between purchasing, operations, and finance. Good communication between these aspects of the business ensure that the company does not overspend and can meet production schedules and customer expectations.

Direct Procurement (Continued)

The purchasing function should have processes and controls in place to ensure that there are no oversights or mistakes made. Some examples of these processes and controls are re-examining the re-order points of items on a regular basis to make sure they meet current manufacturing or production schedules. Consistent reviews of items such as open purchase orders, including blanket purchase orders, and any consignment agreements are another example. There should also be in place a verification mechanism to ensure compliance. These mechanisms do not have to be complicated and detract from daily operational responsibilities, but should be adequate enough to provide oversight and assign accountability. Frequency is also important as well and should be dictated by volume and how critical accuracy is. If there are a significant number of purchase orders issued on a daily basis, the review processes need to be completed either daily or weekly to prevent a backlog. In a situation where highly specific quantities or types of raw materials are needed, frequent reviews should also be conducted to prevent delays in the manufacturing or production process which can have adverse financial effects on the business.

Another consideration is the managing and tracking of delivery confirmations and the management of cancellations and returns. Confirmation of delivery or non-delivery must be available in case of a situation where legal recourse is required or in the event of a dispute with a vendor. Partial shipments of goods can create significant purchasing and inventory issues and need to be effectively tracked. Cancellations must also be closely tracked and communicated with vendors. Any open items on purchase orders to vendors are considered to be open liabilities until closed.

Indirect Procurement

Indirect procurement is the procurement or purchasing of items that are not for production such as MRO items. Unlike raw material costs which are recovered when items are sold, costs related to indirect procurement are not directly recovered during the course of doing business. This means that effective strategy and controls for managing indirect procurement are extremely important.

Like direct procurement, strategy dictates purchasing methodology. This covers what, when, and how many items need to be purchased. However, since indirect procurement costs are typically not recovered, this strategy also needs to focus on the value items bring to the business and the necessity of their purchase. For example, if a raw material cost goes up, there is the opportunity to pass on that cost increase by increasing the price of the finished product. When the cost of an MRO item goes up, unless finished good prices are increased across the board to compensate, the company absorbs the cost increase. Therefore, indirect procurement costs need to be carefully scrutinized on a consistent basis to ensure they are not adversely affecting the profitability of the company.

Controls governing indirect procurement are critical as well. Take for example the situation of a company where everyone who works in the office has the ability to go online and order office supplies on a company account. While it may be simple for employees to order supplies when they need them, the company has virtually no control over office supply spend. A better solution would be one employee who places orders for supplies on a specific schedule and is responsible for keeping track of existing inventory. The controls of having one point of purchasing and limiting purchasing to specific times allows office supply costs to be better managed.

CONCLUSION

Proper inventory and procurement management can create competitive advantages for small, privately-held companies. By developing an understanding of the basics of each and how they apply to an individual company, it is possible to devise and implement effective solutions which minimize cost and maximize cash flow.

ABOUT THE AUTHORS

Maurice Nassar is the Managing Partner for Emergent Partners. He has served in a variety of positions for companies both large and small in management and as a business consultant. Formerly the Chief Financial Officer for a privately-held, international company, he was responsible for building the processes and infrastructure which led to exceptional growth. Throughout his career he has developed the business model and methodologies that Emergent Partners uses to help businesses improve their operations and succeed in their respective markets.

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