

# Optimizing Inventory? Go Beyond Your Supply Chain

When excess inventory is sitting in a warehouse tying up working capital, leadership is left to react to the problem instead of proactively mitigating it. More often than not, organizations turn to their supply chain function to reduce inventory and answer for the sins of others. Inventory, one of the largest components of working capital, often represents a huge cash outlay. The critical task, that is often overlooked is monitoring and optimizing inventory. To truly address the root cause of inventory creep, organizations need to work with other functional groups (marketing, sales, finance) not traditionally associated with inventory management and hold them to account.

## Marketing

First, let us examine the marketing function. Inventory cannot exist without the decision, typically made in marketing or merchandising, to carry an SKU and/or new products. Most companies lack the necessary tollgate rigor when introducing new SKUs, and rarely is there a closed loop that holds marketing or merchandising accountable for failed SKU introductions.

In addition to implementing tollgates as SKUs are introduced, we also recommend regularly reviewing

the SKU portfolio, as we frequently encounter the 80/20 rule, where 20% of the SKUs bring in 80% of revenue. Typically, this is due to marketing failing to manage a product through its entire lifecycle. The SKU is typically promoted throughout its development, growth and maturity, and then forgotten during its decline. Culling low performing SKUs is one of the best ways to optimize inventory levels, but this needs to be a decision made by marketing, not solely by the supply chain function.

### Best Practice | In Action

FTI helped a client define a framework and evaluate the cost of complexity associated with introducing a SKU. This framework took the typical inputs from the business case of a new product introduction and added in an allocation for supply chain cost. This model helps provide a more accurate depiction of SKU profitability in a distribution environment.



**Front-end management of the SKU introduction process can often prevent unprofitable SKUs from being introduced in the first place. We recommend a rigorous and formal process with documented tollgate approvals and established business case templates. While this “best practice” is well known, we find that it is rarely implemented effectively.**

## Sales

The sales department should be extensively involved and held accountable for the accuracy of demand forecasts. At the very least, they should share responsibility for unprofitable sales that are recurring or avoidable. Traditionally only the supply chain function is accountable for inventory excess and obsolescence (E&O), but it likely originates from actions taken by the sales team. It is impossible to sustain inventory reductions in the long term without supply chain being closely aligning with sales. If the supply chain team builds inventory levels to match sales predictions, but actual sales come in much lower, the supply chain function feels the impact of an increase in inventory to meet commitments made by the sales function. Often

by the time inventory effects of these decisions are recognized, the forecasting commitments of the sales team have been forgotten (e.g., sales commit to holding inventory for a customer that is unprofitable, or a sale is made months in advance of the agreed delivery date without considering price increases and carrying costs).

Without alignment with the sales function, significant discounting, write-downs or even write-offs can be expected. Involvement and participation of a cross-functional team comprising sales, marketing, finance, operations, planning and others are the key to balancing supply and demand and leveraging the sales and operations planning (S&OP) process.

### Best Practice | In Action

At a client who had experienced growth through acquisition, we found significant differences in how the legacy organizations were managing stocking agreements generated by the sales team. Standardizing the process and shifting the philosophy from how stocking agreements were managed, the company was able to shift more of the burden to customers in instances where original sales projections were not met.



**Along with their rigor in the S&OP process, we have also seen our clients succeed in balancing supply and demand by aligning sales compensation to profitability as opposed to revenue. While this approach can be more challenging than simply measuring revenue, we find it to be a best practice.**



## Finance

After considering the macro decisions made by marketing and sales, the micro decisions around inventory are made by finance through policies and accounting practices. High inventory levels manifest themselves as working capital on the balance sheet. This can negatively impact cash flow, as money is tied up in inventory that may not sell at the projected volumes and prices. Finance leaders typically look to their counterparts in operations/supply chain when faced with the need to reduce inventory. What they don't realize is that policy decisions (i.e., payment terms, credit terms, invoicing/billing requirements) taken by the finance and accounting

function can negatively impact inventory levels.

Additionally, the finance planning cycle and budgeting processes are often based on historical budgeted amounts. This disconnects them from the operating realities of warehousing changes, supply chain issues and current inventory positions.

More often than not, focusing on the supply chain function to reduce inventory levels is akin to addressing symptoms instead of treating the underlying disease. It might lead to a temporary reprieve, but if the finance function doesn't change its practices, the problem will reappear in due time.



**We have also seen instances where the supply chain function is the default path of escalation for vendor payment issues and inquiries. This additional responsibility that traditionally resides within the finance function can take bandwidth away from the supply chain team to more tightly manage inventory control.**

### Best Practice | In Action

The finance department of a client with significant repair and maintenance operations had previously given the directive that used parts be depreciated and placed back into inventory rather than being written off. This directive drove the company's inventory value to appear higher in terms of book value as opposed to market value, since many of the parts had become obsolete. After a thorough inventory of replacement-parts, FTI was able to identify and eliminate obsolete parts, resulting in a significant reduction in inventory. Introducing new metrics for measuring inventory value and turnover improved visibility and helped the company to strategically refocus its accounting practices and drive warehouse-level behaviors.

## Conclusion

Depending on the culture of the organization, the supply chain function may be less strategic and more of a facilitator of the storage and movement of inventory. As a result, supply chain leaders can get caught overseeing the tactical challenges of labor, carrier and third-party logistics management, and may not feel ownership of inventory levels. Often times, stale or untimely metrics are used to manage inventory levels, and the supply chain team doesn't feel empowered to raise a flag to the marketing, sales or finance functions. Our experts find that there is a tendency for supply chain leaders to use aggregated data

to spin a positive storyline about inventory controls and don't have the incentive to provide more granular inventory metrics. Finance leaders may look to ABC analysis driven by demand/consumption rate and days-on-hand inventory to actively identify and address E&O issues. It is easy for the supply chain function to manage and report on finished goods inventory, but often there is a significant amount of capital tied up in raw materials, work-in-process and maintenance, repair and operations inventory in support of the production of finished goods.

Inventory-intensive industries typically flourish during growth periods at the expense of loosely implemented inventory policies. Strategies to manage working capital are best implemented when times are good, so that companies are better prepared to face the rigors of economic downturns. In the current economic climate, implementing improved inventory policies can become a matter of survival. Based on FTI's analyses and experience, the following are potential tactics to more tightly manage inventory/working capital:

| Function                    | Best Practice  |
|-----------------------------|--|
| Marketing/<br>Merchandising | 1 More stringent new product introduction tollgates and product lifecycle management |
| Sales                       | 2 Improved demand forecasting  |
| Finance                     | 3 More aggressive write-offs and write-downs for E&O inventory                       |
| Supply Chain                | 4 More accurate and granular inventory visibility and reporting                      |
| <b>ALL FUNCTIONS ABOVE</b>  | 5 Rigor in S&OP cross-functional alignment and accountability                        |

In addition to these areas, FTI recommends **creating an expedited dashboard that highlights potential issues with your inventory management**. This leads to deeper analysis of focus areas and addressing the root cause of issues, not just resolving the high-level symptoms. **Proactively segmenting customers and vendors** will help inform tailored policies to more aggressively manage inventory while mitigating the potential negative impacts of change. Inventory management teams usually focus on guaranteeing constant supply, but they can lose focus on E&O stockpiles they are facilitating, and often do not make the connection to bottom-line profitability. Tools for visibility are important to manage inventory; **invest in robust reporting visibility to detect inventory trends** as they occur instead of managing them after the fact. Creating an initial organization-wide picture followed by establishing granular tools and processes that can govern underlying demand assumptions, order parameters and inventory and safety stock levels.

While a system-wide view is a good starting point for improved inventory management, **a comprehensive program which drives alignment and accountability across functions is necessary** to change behaviors and maintain optimized inventory levels in the long-term. **Reassessing and improving your S&OP process and defining/assigning relevant metrics** improve consistency, accuracy and timeliness of inventory reporting while building a platform that educates and empowers all stakeholders. In comparison to typical belt-tightening measures, improving working capital through better inventory management is less painful because it leverages existing teams and personnel by holding leaders accountable across the organization, not only supply chain professionals.

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