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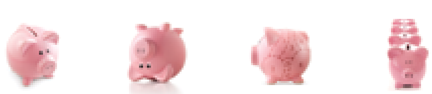
Make your working capital work for you

Strategies for optimizing your inventory management



Part of the Deloitte working capital series

The Deloitte working capital series

Strategies for optimizing your accounts receivable

Strategies for optimizing your accounts payable

Strategies for optimizing your Cash management

Strategies for optimizing your inventory

Most businesses understand the need to maximize their working capital. Beyond funding growth and reducing reliance on debt or other forms of external financing, increasing cash availability can help you both strengthen your balance sheet and enhance operational performance. Yet a gap exists for many businesses between recognizing the imperative for working capital optimization and understanding what steps to take to improve liquidity.

To help you close that gap, this series focuses on several core strategies businesses can use to free up working capital. The key is to build a cash management culture that revolves around improving your accounts receivable, accounts payable and inventory management processes. This final installment of the series focuses on freeing up working capital through the optimization of inventory management.

Managing the inventory balancing act

Given the cash outlay required to acquire it, inventory often constitutes one of a company's largest balance sheet items. As a result, inventory has a significant influence on working capital. Determining how to carry sufficient inventory to meet demand, but not so much that it affects cash flow, requires a delicate balancing act.

A company must balance the needs of the customer with the goals of the company in an integrated inventory management model where the right inventories are in the right place, at the right time. What is needed is a disciplined process whereby the level of investment in inventory is in line with the expected level of customer service to be provided.

To maintain optimal inventory levels, you need robust systems to accurately track and maintain control of your inventory levels. Internal processes are required to manage your vendors and customers, your supply chain, and to maintain control of your inventory. Such processes will enable you to track inventory performance, monitor demand patterns, maintain accurate inventory counts, and ensure suppliers adhere to their commitments.

These efforts must be underpinned by the adoption of a cash management culture. When it comes to inventory, this means managers must prevent buyers from over-purchasing for fear of losing a sale. Instead, they must put disciplined processes in place to ensure orders are based on real demand, enabling the company to maintain minimal inventory levels without compromising customer service.

Adopting best practices

Before businesses can improve working capital through the adoption of inventory planning initiatives, they extend the responsibility for inventory management beyond the finance function. Everyone within the business must play a part - purchasing, production, sales, marketing and IT must all responsible in some way. For example, through identifying and quantifying the inventory needs of potential new markets, tracking shifting customer demands, spotting seasonal variations and adhering to common processes across the business.

Although there are no one-size-fits-all approaches to inventory management, there are best practices that can guide the way. Some best practices include:

- **Centralizing inventory management** through regional or national hubs to reduce warehousing costs and optimize shipment to end customers, regardless of the channel they use to place orders. As an added advantage, centralizing inventory can often provide you with greater insights into customer purchasing patterns.

- **Strengthening internal controls** around inventory counts, inventory transfers, inventory adjustments, and procurement and sourcing practices to ensure that inventory is appropriately safeguarded, replenished and maintained.

- **Automating processes** to improve the accuracy and completeness of your inventory tracking and help you maintain appropriate inventory levels. It's imperative to maintain accurate master data to ensure all stakeholders get a real-time view of quantities on hand, costing of goods and location of goods. Without this transparency, you run the risk of over-purchasing by buyers who don't trust the master data.

- **Setting up supplier portals** so that suppliers can electronically track the status of orders, delivery schedules, potential product shortages and payments processed. In addition to reducing time spent on these processes, these systems also reduce manual errors, improving order accuracy.

- **Consolidating vendors**, to win price concessions, extend payment and delivery terms, and derive other value and benefits from suppliers. This objective is often enabled by leading organizations through the use of supplier scorecards which are used to monitor supplier performance across a range of metrics – for example, supplier lead time, supplier transit time, material price increases, inventory shortages, and defect rates.

- **Negotiating full drop shipments** whereby suppliers deliver goods directly to customer sites rather than to corporate warehouses or distribution centres, enabling you to reduce both shipping and warehousing costs.

- **Tracking key performance indicators (KPIs)** in order to critically measure performance and improvement across the organization. From an inventory perspective, common metrics include average inventory levels, order fill rates, inventory turnover and Days Inventory Outstanding (DIO), back orders and capacity utilization. Marginal improvements in KPIs can lead to real opportunities in inventory performance and can significantly reduce your working capital investment.

Choosing appropriate reporting levels

The level and type of reports you generate will depend on the metrics you track. For instance, if you look at only high-level KPIs, such as DIO, your reports will be less granular than if you monitor detailed operational metrics, such as capacity utilization, supplier performance, lead times, back orders and inventory turns.

Either way, the key is to select metrics relevant to your business that provide the right stakeholders with real insight into your working capital performance.

Strategies for enhancing inventory management

There are a number of processes within the inventory function that, if optimized and controlled, can help you free up cash and strengthen your working capital:

1. Procurement/sourcing

Businesses need to have appropriate inventory replenishment processes if they hope to maximize their working capital. Although the approach will vary at each organization, most businesses should consider adopting processes for:

- **Ordering and receiving inventory:** this involves selecting between a centralized and decentralized inventory approach; determining when it makes commercial sense to place individual orders vs. ordering in bulk to keep shipping costs down; timing orders to take advantage of discounts; and deciding whether to place orders in advance or arrange for just-in-time delivery. For instance, if you source goods internationally, you may be required to place bulk orders in advance. Conversely, if you work with local suppliers, you may have greater flexibility to have individual orders delivered just-in-time.

- **Customer fulfillment strategy:** rather than making daily deliveries you may be able to reduce costs by delivering less frequently, or you may be able to even delay delivery to some customers. Has your organization completed an internal review of distribution center (DC) and inventory locations? Is inventory located in DC's close to where there is a demand from customers? Unnecessarily moving inventory between DC's and retail outlets should be avoided where possible to prevent incremental freight and handling costs being incurred, and even paying for underutilized warehouse space.

- **Setting up local or offshore supply chains:** in years past, many businesses sourced goods from offshore suppliers in an effort to contain costs. While this strategy can still be valid, Canadian businesses increasingly rely on domestic suppliers for three main reasons: faster delivery, superior product quality, and a desire to support local vendors. If you do choose to source locally, try to negotiate longer terms or larger discounts to offset possibly higher prices.

- **Planning for contingencies:** whether you source locally or internationally, beware the danger of concentrating suppliers in a single region. To mitigate the potential impact of natural disasters or other business disruptions on a single region, it may make sense to source from geographically-dispersed suppliers.

- **Monitoring supplier performance:** as supplier scorecards become more popular, businesses increasingly use them as a tool for negotiating additional rebates or discounts for non-performance. When setting up scorecards, consider tracking metrics such as supplier errors, short or delayed deliveries, product quality, response times, prices and departures from contractual terms.

- **Calculating safety inventory levels:** many companies maintain safety inventory to cover for late deliveries or meet unexpected demand spikes. Calculating safety inventory levels, however, must be handled carefully to avoid either keeping too much inventory that doesn't sell or keeping too little inventory and having to place rush orders. Consider using both automated and manual safety inventory calculation processes, for instance, receiving system alerts when levels get low then having procurement/planning staff review the numbers to confirm if you should place a new order. That way, you can avoid automatically placing orders for inventory that is about to become obsolete or that is losing customer traction.

- **Preparing demand forecasts:** to ensure the highest levels of accuracy, demand forecasting should be the responsibility of various functional units, not just the finance group. Businesses that already prepare demand forecasts should consider the history of their forecasters' past success and the optimal timing for making forecasts.

2. Inventory counts

Before inventory can be effectively managed, businesses must ensure that their inventory records are accurate and that there are processes in place to handle any variances. To improve inventory accuracy as part of a working capital optimization initiative, businesses should:

- **Review the frequency of inventory counts:** you may want to conduct a full count of all inventory located at all properties only once a year, while conducting cycle counts of key or high value Stock-keeping Units (SKUs) more frequently.

- **Manage obsolete inventory**: in continuation of the above, more frequent inventory counts provides a mechanism to proactively monitor inventory which may be slow moving or potentially becoming obsolete, and even inventory that has been lost. Frequent inventory counts may allow you to expedite the transfer / sale of such inventory through fire sales, scrapping, supplier returns, product bundling, or even by giving your preferred customers special deals.

- **Improve inventory count controls:** to enable accountability, give inventory counters clear instructions by detailing regions to count, providing pre-numbered inventory count sheets, properly arranging products to avoid double counting and clarifying processes to prevent counting products already sold. Assign responsibility for the count to either internal staff or a third party.

- **Avoid the mistake of double counting:** identify and isolate slow moving or obsolete inventory to prevent its inclusion in final inventory numbers. Decide how to identify and count goods in transit (GIT) and consignment inventory, and perform counts at different locations simultaneously to prevent staff from moving goods between locations in an effort to cover up losses.

- **Reconcile inventory variances:** during your inventory count you will inevitably encounter some variances between the general ledger and physical counts. Where variations are significant, businesses may choose to go through several recounts, investigate if specific SKUs show frequent variances or bring in different teams to count each time.

Getting cash fit

Accurately predicting customer demand and working with suppliers to adjust orders in real time are no easy tasks. That's why businesses need standard processes in place to track inventory performance, monitor demand patterns, maintain accurate inventory counts and ensure suppliers adhere to their commitments. Approached strategically, and bolstered by executive-level support, this type of inventory management initiative can free up working capital and strengthen your balance sheet.

To help you realize these benefits Deloitte's working capital professionals work with your teams to tactically implement new processes, monitor and track your performance and share specific action items your staff can take to optimize your inventory management processes. You work hard to earn your cash. Isn't it time to get your cash working hard for you?

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