Inventory Is Not a Problem; It is a Symptom

An Executive Overview

Imagine the **possibilities**,
realize the **potential**.®

The president of a client company asked the all too common question:

“We have an inventory problem! We always seem to have too much, too little, or the wrong mix. This is a ‘front burner’ problem, and I’m leaning hard on my supply chain team. But as soon as we fix one thing, another inventory issue crops up. And we scramble to the end of every quarter. What do we need to do differently?”

The answer is often not what the president expects:

You need to view inventory differently!

While the symptom, inventory, is easy to see, ***inventory itself generally is not the problem.*** Surprising to many executives, undesired inventory levels are a symptom of other, larger problems; most often, the impact of prior business decisions, misaligned execution, or both.

These three questions help frame what needs to change:

- **Inventory is an essential asset. Do you know how much you <u>should</u> have?**
  The correct answer is not “the number in the budget.” Nor should the ideal number be discovered through benchmarking (See The *Downside of Benchmarking*). Determining the right inventory target requires thorough collaboration between the supply chain, sales and marketing, new product, and financial organizations.

- **Do we understand the relationship of inventory to strategy, capabilities, service targets, and corporate goals?** Inventory should not be governed solely by the Supply Chain organization. It is too narrow of a perspective given the importance of inventory in achieving business goals and strategies.

- **Do we consider inventory an essential asset that <u>requires governance</u>?**
  A bureaucracy is not needed, but we <u>must</u> understand who makes and executes inventory-related strategic and tactical decisions, and in what time frames.

“Executive Leadership is responsible for collaboration, functional alignment, execution… and decisions"

Keep in mind: The executive leadership team is responsible for making better business decisions and ensuring that functions, capabilities, and strategies are aligned. Executive leadership is also accountable for improving execution. Many of the resulting decisions and actions cannot be successfully delegated by executive leaders.

Unfortunately, these same business leaders are often distracted by the symptom: inventory. A key way to answer the president's question, "What do we do differently?", is this: **Stop allowing inventory to victimize the company.** Instead, use inventory *opportunistically.* Inventory is a business investment. It is a tool to increase sales revenue, create customer loyalty, improve efficiency and fend off the competition. Undesired inventory levels are a *symptom*. Use them to determine what caused the inventory in the first place.

Addressing the symptom – unneeded and insufficient inventory – creates two "wins." First, addressing current inventory levels is "low-hanging fruit" that will bear quick results. When the root causes of undesirable inventory are addressed, it leads to the second win. Longer-term issues are resolved, and chronic inventory problems are reduced. Short-term financial performance is improved, and the company is better positioned to attain longer-term business goals and strategies.

In the end, executive teams **leverage the power of inventory** to improve business performance. This white paper gives an overview of an approach many executive teams have successfully used to leverage inventory to drive improved business performance.

Here's how they do it:

First, a change of mindset is required. Business leaders must think of inventory as a *cross-functional asset that requires governance*. Effective governance does not involve creating a bureaucracy. It does mean defining appropriate inventory targets – and who makes inventory-related decisions. It also requires a process that ensures those decisions are properly executed within the necessary timelines. After all, we expect excellent returns on this asset.

Second, the executive team must be willing to open-mindedly analyze the current inventory situation and approve actions to treat the immediate symptom; that is, undesired inventory levels. Business leaders must also be willing to commit the resources to identify the root causes of the inventory situation and take corrective action to prevent recurrence of the problem. Doing so generally requires tough, cross-functional decisions.

Lastly, the executive team needs to implement and sustain the behaviors – and honesty – required to maintain the gains achieved through inventory governance. In addition, the targets must be periodically reviewed to validate their effectiveness. The executive team needs to support the activities required to address any issues that prevent achieving the targets.

Summary: It does not require a bureaucracy to support these needed behaviors and actions. It does require a cross-functional inventory policy to identify and authorize actions to maintain and improve the "new normal."

Quick Steps to Successfully Establish Inventory Governance

The following three simple steps to establishing inventory governance can be accomplished in a short amount of time – and need to be. Inventory issues should not be permitted to be a chronic condition. Remember, symptomatic relief and analysis are usually a "one time fix" and has a remarkably short shelf life.

These three steps help to quickly attack inventory issues: Understand, Correct, and Sustainably Improve.

1. **Understand** – the first step – must be driven by the executive team working collaboratively to understand where inventory fits in the business strategy and the amount of inventory needed to support the strategy.

2. **Correct** – the second step – must be owned by the executive team but driven by a collaboration of these functional organizations: supply chain, production, sales, and finance. The key managers of these functions work together and seek executive team approval of recommended decisions and costs associated with those decisions. This effort must have visible and consistent executive support as well as swift actions on the required decisions.

3. The third step – **Sustainably Improve** – is owned and driven by the executive team and cross-functional management teams with a focus on improving business performance.

Following is an overview of each step.

1. UNDERSTAND why inventory exists and the financial and service tradeoffs, then set targets

**"Inventory is an essential asset.
Do you know how much inventory you should have?"**

Another way of asking this question is: "Have we adequately defined the problem we are trying to solve?"

To be effective, inventory targets take into account customer goals, service, efficiency, and financial aspects of the business.

The executive team must understand how inventory supports the business strategy, capabilities, and goals. Questions to ask and answer include: Do we need reduced lead time to customers to better compete? Must we be positioned with product to achieve growth goals prior to gaining customer commitments? What investments have we made (are we willing to make) in Lean initiatives, flexible supply or improved expedite capabilities to support customer needs? Does inventory support production efficiencies and lower operating costs? Tradeoff decisions will result from answering these questions.

Once the executive team agrees on how to leverage inventory to support the business strategy, it becomes relatively easy to set inventory targets. Setting targets is not just a mathematical exercise. It is highly dependent on underlying assumptions about operations, uncertainty, capabilities, and demand plans. It also involves defining financial and customer service tradeoffs. Risks and opportunities should be identified and documented. Hence, the need for alignment between operations, sales, and finance.

Note that inventory is not the only way to appropriately meet customer demand, but must be balanced against other methods of satisfying the customer needs. These alternatives include quick-turnaround production, expedites, and asking customers to wait for product delivery while the supply is produced (via deferred production, assemble-to-order, or other techniques).

When considering other alternatives, the financial impact and consequence to market share must also be considered. Therefore, this is a cross-functional activity to gain alignment of the supply chain, production, sales, and finance management teams.

The resulting target number will not be precise, nor does it need to be. It will be roughly right, and highly effective in identifying whether the right amount of inventory is currently on hand or projected to be available.

The Downside of Benchmarking

Setting inventory targets based on benchmarking is a flawed exercise. No two companies will be alike in their strategies – and their capabilities.

Benchmarking, even within an identical industry, only tells part of the story. It often gives better insights on the competition's supply chain and capabilities than yours.

The focus when setting inventory targets needs to be determining what volume and mix are "good" in supporting your business strategy and goals, given current and future capabilities. Once that is considered, scenarios can be run to see how your capabilities and aspirations can better the competition.

Once decisions are made on the ideal inventory target, it is important to routinely revisit the company's balance point – and whether the tradeoffs remain acceptable. For example, an investment to change supply capabilities that creates faster turnaround may mean less inventory can be held. Before the investment decision is made, modeling should be created to demonstrate that faster turnarounds will result in reduced inventory. Modeling and scenario planning are critical to validate that the inventory, service, and financial decisions made in approving the target are having the desired effect; that is, the achievement of business strategy and goals.[1]

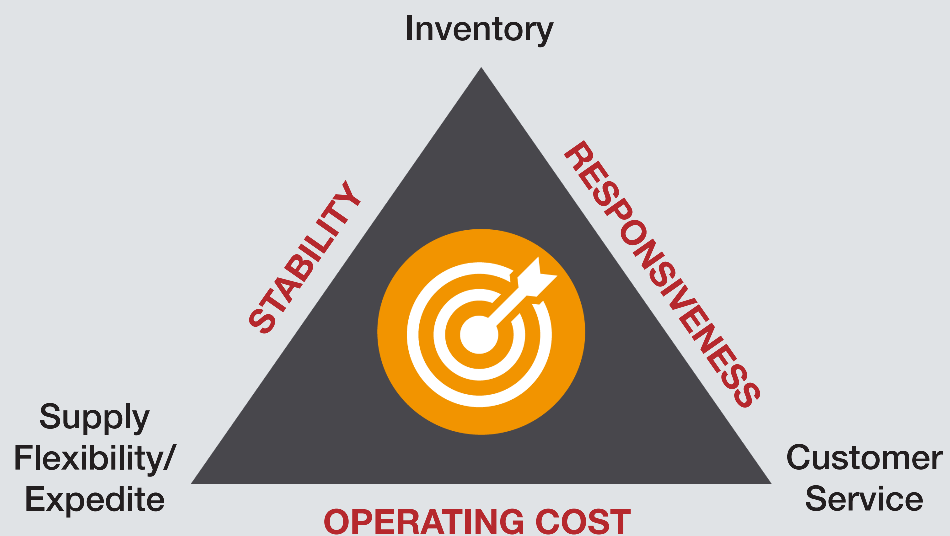
[1] Pamelyn Lindsey, Scenario Planning: A Necessary Skill to Drive Better Decision Making in Integrated Business Planning, www.oliverwight-americas.com, under Resources/White Papers

In performing the analysis and making recommendations described above, expensive software is not necessarily required. Decision-making boundaries and authority must be well defined and respected, however. Tradeoff decisions that impact financial performance and customer service or deviate from the business strategy, for example, should be made at the executive level.

When the above described key elements are included in inventory governance, the executive team generally notices two changes: There are fewer crises in serving customers, and there is a greater likelihood in attaining business and financial goals.

The Role of Inventory in a Service Level Strategy

A company's service level strategy should be considered as a part of its business strategy. All too often a service level strategy is ill-defined, limited to the supply chain organization's assumptions, or neglected altogether.competition.



A service level strategy covers the three general options usually available to serve customers:

1. Have the right inventory available when needed
2. Flex supply as needed to fulfill orders (through such tactics as expedite, make immediately, or assemble to order)
3. Establish lead time, where customers wait an amount of time to receive their orders.

Knowing which balance of the above options works best for your company and customers is critical. The agreed upon service level strategy – and accompanying investments - may vary by market segment, product type, and individual customers.

The strategies must be well thought out. Clear, communicated alignment at the executive level is imperative.

2. CORRECT inventory that is not aligned with agreed upon targets (and the assumptions behind them)

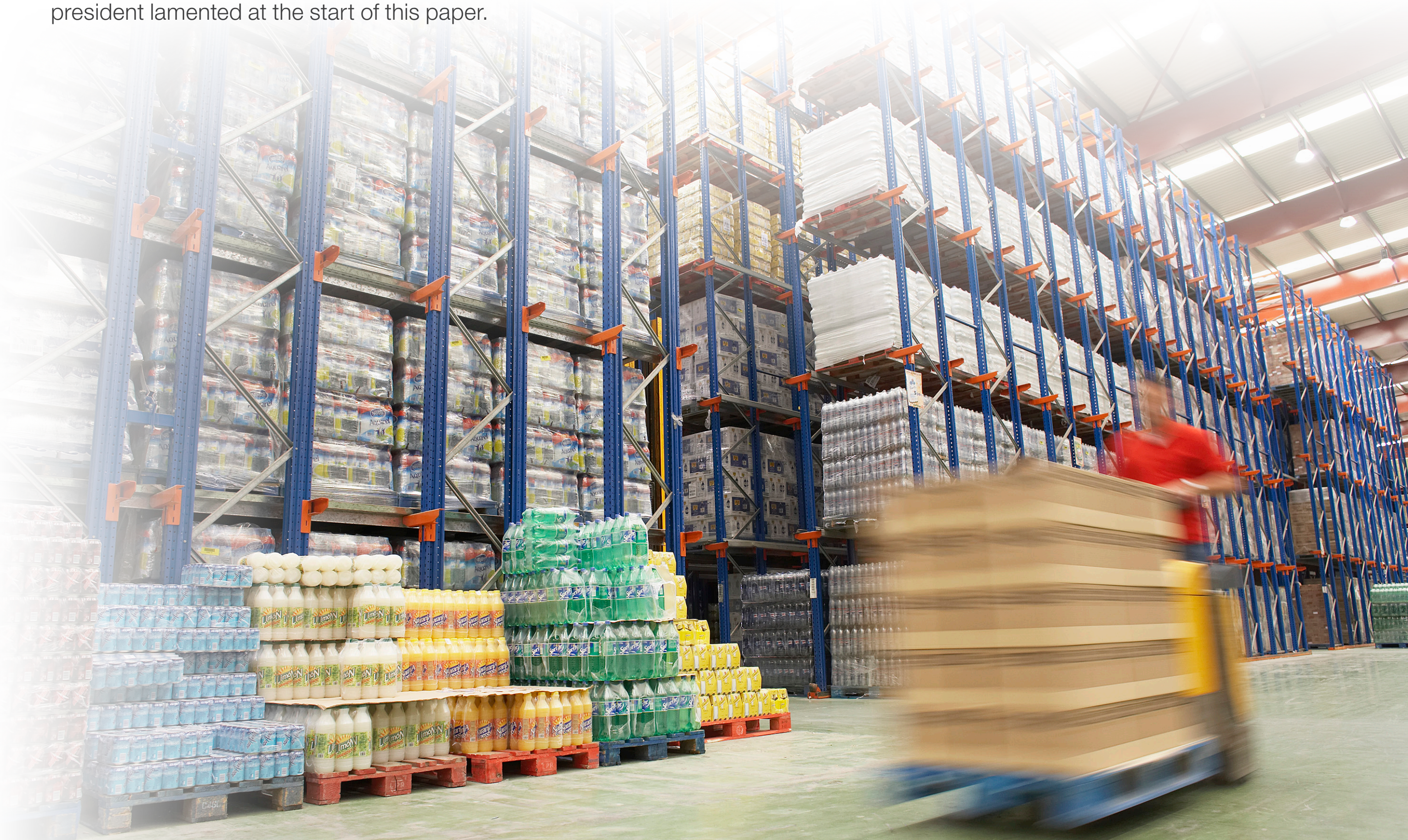
Once the inventory tactics to support the business strategy are understood and corresponding inventory targets are set, the focus shifts to execution. A first action is usually to analyze the current inventory levels and plans against the targets. The result of this analysis should trigger the following regular and routine process:

- **Deplete any inventory that is not needed as quickly as possible, preferably by selling it.** This should be treated as an urgent activity, requiring cross-functional collaboration to be successful. Assign responsibility and (short) timing for this to be accomplished. Monitor.

- **Analyze and determine root causes when actual inventory misses the target range (high or low).** Prioritize corrective actions, and triage as necessary. Reassess to make sure the root causes of the problems are fixed and undesirable inventory levels do not persist.

- **Maintain course by regularly revisiting targets.** Ask and answer these questions: Is inventory still at the appropriate level? Do we have the capability to maintain the inventory target? Can we still afford the tradeoffs? Have changes been made that require re-setting the inventory target? Make appropriate decisions promptly when the inventory target proves to be infeasible.

Depleting inventory that is not immediately needed relieves the inventory symptoms of the root problem. This relief should motivate the team to further action to prevent the inventory problem from rearing its head again. Only solving the root causes will prevent inventory from becoming a chronic issue that the president lamented at the start of this paper.



Root cause analysis inevitably drives companies to challenge their practices. These questions typically emerge: Are the agreed upon, practices not executed? Do people understand their roles and "play their positions"? Are there problems with execution (sales, marketing, production, and logistics) that have not been addressed?

As the doctor says, "You will feel some discomfort" addressing these issues, especially when faced with the stark financial realization that current inventory may be over-valued. My advice: Persevere!

The other end of the spectrum also causes distress. Some executive teams may find supply capability is insufficient to create *enough* inventory or properly position inventory to satisfy customer needs. This realization can hit leadership hard, especially when it reveals the lack of thorough forward thinking when making supply investments or considering other elements of setting the inventory targets.

Often the resources needed to actually supply enough inventory have not been considered or provided, or are not living up to their stated capabilities. Also, using too short of a planning horizon will not take into account anticipated changes to demand or supply capabilities over time. An overly optimistic or pessimistic view provided by various business functions may also lead to skewed decisions about capabilities.

Whenever hurdles are encountered in achieving the targets, the response should be swift. Trouble achieving the targets generally reveals uncomfortable operational and financial disconnects; in many cases these are consciously or unconsciously hidden. No matter the source of the disconnects, decisions on corrections must be made and corresponding actions taken.

Determining the needed corrections can be a painful and introspective process. It often involves changing practices and behaviors, which requires executive leadership to be effective, let alone sustained. Tradeoff decisions must also be well-informed and supported by leadership.

3. SUSTAIN improvements by implementing behaviors, policy, and feedback mechanisms

By this point, changes have been proposed and many executed. Now, these improvements must be sustained! Sustainability is created through leadership's well-communicated expectations that address behaviors, practices, and policy.

The needed behaviors must become the "new normal." Creating this new normal involves change management, driven by better practices and supported by a more honest culture.

An inventory governance policy helps reinforce the needed behaviors and paves the way to better practices overall. One objective of the inventory governance policy is to ensure that the inventory symptom is used to illuminate the root-cause issues for resolution.

Enterprise Policy/Procedure: **DOCUMENT NUMBER:**

Inventory Governance Policy/Procedure

Reviewed by: ______________________ **Date:** ______________
Name Title
Approved by: ______________________ **Date:** ______________

1.0 Overview	Inventory is utilized to cost effectively meet customers' demands for products. It represents a significant investment of working capital and, therefore must also meet strategic, business plan and financial objectives. Finished goods inventory levels, as they are decremented by actual shipments, also signal the need to produce replenishment quantities of product, with specific dates and quantities, and to drive clean signals to acquire the necessary resources to do so.
2.0 Process Owner	EVP Global Supply Operations

Remember that many of the root causes (likely most of them) are not in the supply chain domain. The most cited reasons for undesirable inventory levels include: Untimely product development information, product lifecycle management practices, inadequate or poorly timed sales and marketing information, and misaligned expectations between the commercial and supply sides of the business (often confused as "bad forecasts," but rarely that simple under scrutiny). Thus, sustained inventory governance is a cross-functional practice and is owned by the executive team.

When inventory governance has lapsed, it will be obvious. The president at the start of this paper will once again be grappling with chronic inventory and service issues that are seemingly never resolved. The symptom of "bad" inventory levels remains, and root causes that result in undesired levels of inventory are ignored or covered up.

A common attribute when inventory governance is sustained and effective is this: The attitude towards inventory is very different. Inventory is considered a good thing when well managed. It is used as a powerful tool for executing the business strategy and goals year after year. Service levels are likewise tied to *overall* company performance, not simply answering the question, "Was it in stock?"

So what happened to the president and company cited at the beginning of this paper? When the president asked, "What do we need to do differently?", it was not a theoretical question. He led the business leaders through the three steps described above. He and his team did not always like what they discovered, but they took appropriate action.

The president confided that going through the process built skills that the executive team has used over and over again. Today, inventory governance is second nature.

The president was hopeful that financial performance would improve as a result of inventory governance. And it did. **The most significant financial results were improved operating margins and increased cash. Unexpected pleasant surprises included increased sales revenue and increased market share.**

In digging further, it stood to reason: By evaluating the appropriate inventory targets for the long term, the company now not only proactively recognizes changing service and inventory needs when a product enters "end of life," but is also better positioned to fulfill demand during product launches.

"Now, when our competitors stumble, we are positioned to fill the gaps," the president observed.

Thank you for reading this paper.

It is not possible to cover all the aspects of inventory governance in the format of a single paper. I am happy to answer your questions and to discuss the concepts of inventory governance further with you. See my contact information at the end of the paper.

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