How to Set Up Inventory Levels That Match Your Business

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Every business has distinct characteristics. Understanding and evaluating each of those characteristics is important, especially when it comes to establishing inventory levels for your company. Each company, based on the specifics of their business, can establish an optimum inventory level.

We begin by looking at inventory. What is inventory? Inventory is the ‘stock’ that you hold that’s used to meet customer demands. The customer can be an internal business unit or an end customer.

The next logical question is, why do you hold inventory? You hold ‘stock’ to insure that you have product that the customer might need. Customer demands are sometimes erratic and supplier performance often unsure. You need to ‘hold stock’ to insure that you have what the customer needs.

After you know what inventory is and why you have it, there’s one last question. How much inventory should you hold to support your business? Unlike the previous two questions, answering this one isn’t nearly as easy, although it does have a logical answer. To arrive at the answer, look at your business from five different dimensions. Within each dimension are several different characteristics. The five dimensions are as follows: Products, Forecasting, Purchasing, Distributing, Customers

We’ll look at each dimension individually.

Products:

Begin with the products you sell. You can understand much about them by answering the following questions:

1. Are the products commodities, or are they custom-made?

If your products are commodities, are they readily available and common? If this is the case, you probably won’t have to hold much inventory. Commodities are usually easy to get and can be replenished quickly. If your products are custom-made, they’ll require different treatment. Custom-made products aren’t readily available. These two characteristics will require different inventory approaches.

2. Do the products turnover fast or slow?

What is the velocity of your product? Does it move fast or slow? If it moves fast, then you’ll need a different approach than if it moves slowly.

3. Are the products of high value or low value?

The value of your product will have an impact on your inventory. If it is a high-value product, do you want to hold it? If it’s a low-value product, it may make it easier to hold a larger inventory. You may choose to hold low-value inventory rather than address other, more expensive inventory issues. The product value is an important inventory question.

4. Are the products sold individually or with options?

If your products are sold individually your inventory is less complicated. You hold the inventory necessary for the ‘individual’ product in question. If your products are sold in combination with other products, your inventory position is more difficult. The product ‘combinations’ will demand more inventory to make up for the uncertainty and complexity.
5. Do the products have a shelf life? If they do, is it short or long?

The shelf life of a product is how long it remains in a saleable condition. The obvious product with a shelf life is a perishable. Fruits and vegetables come to mind. But computers have a shelf life too. Due to the rapid changes in the expensive technical components, a computer can become outdated very quickly. You must decide if your product has a shelf life. If so, how long is it? The length of the shelf life will dictate a certain inventory level to support the customer.

6. What are your products' order lead-times?

Order lead-time is the time between when you place your order and when it arrives. Your products individual lead-times will dictate the amount of inventory to hold. If you have a long lead-time then you need to buffer your inventory to protect customers. If the lead-time is short, you can adjust inventories downward.

Your product portfolio dictates the amount of inventory you need. You need to consider these characteristics individually and together. The combination of these characteristics will help you establish the right inventory level for your business.

Forecasting:

A forecast is nothing more than a prediction of tomorrow's orders. You're trying to predict what products your customers will buy. Based on your prediction, or forecast, you will purchase your products. You will probably have to place some of these products in inventory. Your products and your customers impact the accuracy of your forecast. Answering these questions will help you focus on better forecasting accuracy:

1. Do you have a forecast process?

You must forecast your product needs. Your forecast process should be no more complicated than your products and customers. Keep your forecast as simple as possible. Measure your forecast accuracy from month to month. Your ability or inability to forecast will dictate a certain level of inventory. The better you are at 'predicting' your product needs, the lower your inventory levels will need to be.

2. Do you know the characteristics of your products?

In addition to being one of the five dimensions of inventory control, product knowledge plays a role in forecasting. You need to understand your products. How long does it take to build them? How long to ship them to you? Is there some limit as to how long they should sit in your warehouse, due to being perishable (as in the case of many food products) or technological obsolescence (often an issue for computer products)? You need to be sure you know everything there is to know about the products you offer for sale. The more information you have the better your forecast will be.

3. Do you know your customers behavior?

You need to know your customers as well as your products. How often do your customers buy? Why do they buy? How many times do they buy? The answers to these and other customer questions will provide the information needed to produce an accurate forecast. Good information is essential to good forecasting.

You'll need to establish an optimum inventory level for your business. That means that you need to become good at forecasting. You'll need to pay attention to the process, the products and the customers.
**Purchasing:**

The terms you're given for the purchase of your products impact your inventory. If you're required to buy large lot sizes, that will cause inventories to increase. If you can only order weekly versus every day, that will increase your inventory levels as well.

It's in your best interests to understand all you can about the constraints that exist in your process. The more knowledge you have of the process the better decisions that you can make regarding your inventory. The purchasing constraints are very important.

**Distributing:**

Your method of distribution will impact inventory levels. If you sell directly to customers it won't require additional inventory. If you sell through other channels of distribution, the channel you choose will dictate a certain level of inventory.

You see many examples today of various distribution methods. Dell chooses to sell directly to the end customer. Their low inventories are legendary in the computer industry. Others in the industry choose to go through 'channels' and have several weeks of inventory in comparison with Dell. The only right answer is the one that's right for your business. Your 'go to market' strategy will dictate your level of inventory. It is a choice you’ll make after considering all of the six dimensions.

**Customers:**

Your customer characteristics will dictate a certain level of inventory. You need to know what they will demand. It’s important to understand what they expect of your company. You’ll gain a better understanding of their needs by answering the following questions:

1. Do your customers want it 'right now' or will they wait?

   It’s important to consider the urgency your customers feel. It’s also important to understand if their buying patterns are the result of their behavior or yours. Do you drive their behavior by your promotions? You must make sure that you understand your customer’s demands.

2. Are they more interested in getting the product when promised or do they want it immediately?

   You need to draw a distinction between opposing customer needs. Do they work from a promise date or do they buy on impulse. You need to try to educate your customers whenever and wherever possible. Bear in mind that customer priorities, when placing orders, will often be a function of your own lack of predictability. Customer demand will drive inventory levels.

3. Do your customers buy in a reasonably predictable manner or are their patterns very erratic?

   You need to thoroughly understand your customers buying patterns. You need to know how they buy, what they buy and how often they buy. You’ll need to establish an inventory level that supports the activities of your customers. Their behavior is one of the key ingredients.

By paying attention to these five dimensions you can establish an inventory level tailored to your business. You’ll need to look at each dimension individually, as well as considering the combined impact of all five dimensions. By carefully considering these five dimensions, the characteristics of each and the impact of the combinations of all five, you can make a difference in managing your inventory.