Reasons for holding inventories

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Introduction

According to the New York Times (1999), the international toy manufacturer Mattel incurred a 500 million dollar shortfall in the period after Thanksgiving all the way up to the end of 1997. This was due to the fact that its main retailer Toys“ R” Us decided to reduce its inventories for fear of costs associated with holding excess stock. As a result, Mattel announced that it would require its retailers to place full orders prior to the Thanksgiving holiday in future so that it could match production and demand more closely in order to avoid such shortfalls in the future. The example given clearly illustrates the consequence of poor inventory management on company revenue. However, if a company is to maintain an inventory of its goods, it must address the issues, such as size, cost, control and estimated demand for its goods or face holding goods that nobody wants to buy.

Reasons for holding inventories

Atrill, McLaney, Harvey and Jenner (2003) identify four key reasons why companies hold inventories:

- Firstly, companies ‘ stockpile’ their goods to avoid the effect shortages might have on customer good will. This could influence the said customer to source his/her needs from elsewhere, usually at the expense lost sales.
- Secondly, by holding an inventory, the company is actually hedging against the possibility of future price increases.
- Thirdly, companies that hold goods inventories above a normal level are better suited to ‘ ride out’ market fluctuations based on irregular or

seasonal demand, thus avoiding lost production or supply (Atrill & McLaney, 2009: 415).

- Fourthly, companies maintain inventories for strategic reasons. For example, the use of quantity discounts to promote greater customer goodwill and help the turnover of stock being held.

Nevertheless, as Atrill and McLaney (2009: 414) point out, there are significant costs attached to holding inventories, namely storage and handling costs, financing costs, costs associated with theft, obsolescence and damage and last, but not least, opportunity costs of investing money in the form of a particular good vis-à-vis other investment options.

The need for inventory management

Clearly, then it is crucial that management assesses the inventory levels accurately as they have direct financial implication for the business, namely in the tying up of capital resources (IFWF, 2007). Therefore, it is vital that management is able to accurately assess the required levels. This can be done through the budgeting process (i. e. budgeting for demand (Atrill & McLaney, 2009: 416)). Or alternatively, management can employ a number of techniques that will allow such assessments to be made. For instance, according to the Institute For Working Future (2007), inventories are subject to either high or low rates of turnover. For example, goods that are sold quickly are said to have a high turnover rate while the opposite is true of goods that are sold more slowly. By using financial ratios (Atrill & McLaney, 2009: 416), the inventory turnover rate can be calculated and proven useful to management decision-making. For example, a higher rate of turnover will correspond to a lower inventory rate average (IFWF, 2007). This situation can

be most advantageous, as a lower inventory level tends to make cost savings (e. g. lower storage costs and insurance premiums) (Atrill & McLaney, 2009: 418). Furthermore, management may introduce recording and reordering systems to answer the question how much to order and when to order. Such systems allow management to check that their records tally with actual goods held and when to factor in ' lead times' to meet demand (Atrill & McLaney, 2009: 417). With regard to the thorny issue of how much should be kept in the inventory, management can use economic order quantity models to predict the demand for a particular inventory (Atrill & McLaney, 2009: 422). Or management may feel that it can do away with the need to hold inventories entirely if it subscribes to a just-in-time system to inventories management. As the inventory is now pull driven, all necessary materials or parts are delivered at the exact moment when they are needed (Broyles, 2005). For example, Broyles (2005) cites the case of Dell Computers that was able to become more responsive to customer needs through the optimisation of its transport and logistics systems resulting in cost savings (and lower tied-up capital deployment in raw material or finished goods) from smaller inventories being held. However, Greenberg (2002 cited in Broyles, 2005) points out " In JIT, everything is interdependent. And every one relies on everyone else." The danger here is evident, namely what happens when there is a disruption in the supply chain due to a labour strike?

Working capital issues and inventory levels

The aforementioned paragraph has approached the inventory question from the point of accurately assessing its level so as to reduce cost, and

reordering and supply mechanisms. However, it would be difficult to separate the inventory issue from working capital considerations, as the latter will cover the production cost of those goods, and facilitate and maintain demand. According to Atrill and McLaney (2009: 442), working capital can be defined as inventories + receivables (i. e. payments due from accounts e. g. sales) + cash – payables (i. e. liabilities and debts) – bank overdrafts.

Receivables, payables and cash

In an ideal world, company makes its products or provides its services to a customer and the customer will pay for it in timely fashion. The reality, however, is that our customer usually wants to pay later than the due date on invoice (Atrill & McLaney, 2009: 440), while suppliers want to be paid as soon as possible. Clearly, the selling company must understand and prepare for this operating cash cycle (Atrill & McLaney, 2009: 434) as it will influence the nature of the financing option it will be willing to offer its customers, as well as the financing option it is willing to consider to tide it over in a downturn. Since it would not be in the interest of any company to alienate its customers, it should also recognise the dangers of overtrading (i. e. carrying out more business that the working capital can support resulting in greater pressures being placed on the cash flow that may increase the likelihood of insolvency (BusinessDictionary. com, 2010)). In order to avoid this, the selling company may offer cash discounts for prompt payments, or only sell to these customers that are able to demonstrate their credit worthiness based on the Five Cs of credit, namely capital, capacity, collateral, conditions and character to receive goods on credit (Atrill & McLaney, 2009: 424).

However, it should be noted that the credit option is not without cost for the selling company (e. g. the lose of interest that could have been accrued as well as the reduction of purchasing power, not to mention the cost incurred by administration of bad debts (Atrill & McLaney, 2009: 443)). If the selling company is experiencing cash flow problems because of late payer and bad debts, it may attempt to liquidise some assets to improve the situation (Tutor2u, 2005). Failing that, it may have to consider a trade payables option in the form of a bank overdraft (i. e. a loan secured on the business's assets) to supplement its working capital (Tutor2u, 2005). Alternatively, with regard to mitigating the effects of bad debt on the company cash flow, the company may opt for invoice discounting (Tutor2u, 2005) to raise finance by using its debtors as security from which to borrow money. If the company has production problems that negatively influence inventory levels as well as lost sales from not meeting customer demand, it may be possible for the company to apply for a government grant so as to make necessary capital investments (i. e. the purchase of new machines) that will lead to job creation (Tutor2u, 2005). Alternatively, company production problems can be resolved by entering upon hire purchase, or leasing agreements so as to secure essential machinery to meet increased demand and secure sales (Tutor2u, 2005). Method of financing such as the one just discussed, may be preferable than diluting share capital through equity. Nevertheless, it would appear that the golden rule is not to expose the company to an appropriate level of debt financing, as it could be difficult to repay during an economic downturn (Tutor2u, 2005).

Conclusion

It can be said that inventory management highlights the inter-relationship between identifying and supplying demand cost effectively while offering financing options to facilitate that demand.