



The Distribution Team

We wrote THE BOOK on Distribution Inventory Management

Variable Compensation for the Purchasing Manager

By Jason Bader

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In a previous article, I posed the question, “Who spends the most money in the organization?” Without a doubt, it is the purchasing team or the investment group as I like to call them. Some folks may point the finger at sales. Death from sales is a long, slow, painful death. Death by purchasing is like a rifle shot aimed right at the heart. Turning buyers into investors takes time and patience. It requires management to provide analysis tools and create expectations. Many of these tools are readily available in your distribution software and require no additional investment. Unfortunately, if there is no motivation to use these tools, your purchasing team will keep on buying the same way they have been taught. Let’s face it, money talks.

We can all agree who spends the most money in the company. How do we typically pay this group? Do they have a fancy variable compensation plan based on wins and losses? Most of us reserve this type creative compensation for the sales team. In fact, we tend to focus so much attention on this task that it becomes a never ending exercise. Some folks change the sales comp plan on an annual basis. Don’t get me wrong, this isn’t necessarily a bad thing; but let’s give a little equal time to the folks who can really take a company down. Rather than providing a straight salary or hourly wage, get creative with the compensation of your buyers. Back up your expectations with measurable goals. The results can be extraordinary.

When I design a compensation program, I like to measure no more than five areas at a time. Any more than that can become confusing. Over time these can change to fit the needs of the organization; but keeping the plan simple will yield the best results. Here are a few areas to consider adding to your plan.

Return on Investment

I am a huge proponent of looking at your suppliers much like an investment portfolio. You will have some strong performers and some weaker ones. The ability to recognize which ones provide a substantial return on the company’s investment dollars should be the cornerstone of the purchasing process. In order to rank the suppliers, I like to use the Gross Margin Return on Inventory Investment formula or GMROI.

ANNUAL GROSS MARGIN DOLLARS FROM STOCK SALES

AVERAGE INVENTORY VALUE

Some will argue that the GMROII formula does not give you an exact indication of the dollars you should expect to receive from the investment. Perhaps not. What the formula will do, if it is applied to every supplier in the same manner, is provide a ranking of your suppliers by return on investment. This is where we can establish our baseline.

From the ranking, determine your average GMROII number. For sake of example, let's say that the average number is 2. In theory, for every dollar you invest in inventory, you will receive a 2 dollar return on your investment. From this average, we can state that every supplier above the 2 dollar mark is a performer in our portfolio. Everyone below the line is an underperformer. Here are the opportunities for improvement. If your investment team improves the overall GMROII, don't they deserve some recognition?

Inventory Turns

When it comes to managing inventory, turns is the most talked about metric. Unfortunately, it is often the most miscalculated. Here is the formula I would like you to use:

$$\frac{\text{AVERAGE COST OF GOODS SOLD FROM STOCK SALES IN THE PAST 12 MONTHS}}{\text{AVERAGE INVENTORY VALUE}}$$

Coming up with a good goal here really depends on your industry. For most, a turn rate of 6 times annually is a good goal. For others, 8 might be a better choice. Be cautious about using published industry benchmarks. You just don't know how the other companies did the math. Establish a current turn for the company. Shoot for very modest improvements on an annual basis. It is very rare to have turns jump by a full point in 12 months. Half a point might be more realistic. Faster turns are not always the best bet. What happens when we turn inventory too quickly?

Customer Service Level

Inventory management can be characterized as a balancing act between turns and customer service level. Customer service level, usually stated as a percentage, tells us how well our inventory levels are matching the needs of our customer base. Some people confuse this measurement with fill rate. These are two very different ratios. Let's say that a customer calls and orders 100 saw blades. You have 85 in stock and you will have to back order 15. The fill rate on this order is 85%. The customer service level for this item is zero. You failed to give the customer what they asked for. It is a pass or fail. In this case, we failed. Fill rate is measured at the item level. Customer service is measured at the order level.

Going back to my original question about faster turns, what happens to customer service level? When turns get too high, we tend to have more back orders and our customer service level drops. Conversely, when our customer service level gets too high, our turns reduce and we are carrying way too much inventory. Where is the sweet spot? You should shoot for a customer service level around 95%. If the current service level is

around 80%, establish small improvements over the course of a year. Don't expect the massive jumps.

Dead Stock

This is an area that most distributors struggle with. It is also an area that our buyers have a great deal of influence over. The ability to recognize when a product has passed beyond its ability to generate revenue is the responsibility of a good investor. When something is dead, or better yet dying, we need to cut off the investment. Don't throw good money after bad. None of us like writing purchase orders for DOA inventory, yet we do it all the time. The biggest culprit is that we fail to recognize the time of death.

My partner and I have written about dead stock for years. The first step in any program is to establish a time of death. The most popular is zero sales in 12 months. This can be adjusted for certain vertical markets. Once a time of death is established, we can use it as a measurement metric.

Most companies will start out with a large problem. For example, 10 percent of their overall inventory could be classified as dead. Putting in an expectation of 2 percent on day 1 is not a realistic goal. It may be an eventual goal, but you need to meter it in. Shoot for a 2 percent drop each quarter. Attainable goals tend to be more effective in producing long term habits.

Some of you may be wondering, "If I am measuring Turns, isn't dead stock percentage picked up in the average inventory value?" The answer is yes. Reducing dead inventory will reduce average inventory value, and thus improve turns. Sometimes we need to point people in the right direction. Remember, when they win, we win.

Open Purchase Orders

From my experience, this can be one of the most frustrating situations for a sales person. They make commitments to the customer based on an expected due date, yet that date can come and go. It is the responsibility of the buyer to maintain accurate due dates in the system. They maintain the relationship with the supplier.

Establish a daily habit of reviewing overdue purchase orders. Most systems will have this as a canned report. Each buyer should make contact with the suppliers and correct the expected due date.

Inbound Freight

For most distributors, freight has become an increasingly large part of the overall operating expenses. Fuel prices are driving costs up and suppliers are passing the cost on to the distributor. What percentage of your overall freight spend is inbound? This is where the buyers can help manage our costs.

Depending on how much negotiation flexibility you allow your buyers, there are several opportunities to add net profit to the organization. If the supplier offers us free freight for a 500 dollar order, what will they give us for a 1000 order? If our current usage rates suggest that we can double the order size, why not ask for additional discounts.

Can we get reduced freight prepaid in our smaller branch locations if we raise the prepaid level at our larger facilities? This one worked for me. I just asked the question.

Is it more cost effective for us to send our own carrier to the supplier? What kind of discount can I receive on each order? Many distributors have made inbound freight a profit center rather than an operating expense.

Building a variable compensation plan for your buyers will take some creativity and plenty of thought. My suggestion is to keep it simple in the beginning. Provide plenty of opportunities to win. Try to keep the payout intervals short. Quarterly bonuses are far more effective than annual. The actual payout does not have to be a large percentage of the overall compensation. The opportunity to pick up an additional 10% will do wonders.

If I were to design a simple comp program, I would include these items: Turns, Customer Service Level, Dead Stock and Open Purchase Orders. Set realistic goals and help them achieve the desired results. Over time, I may drop specific goals on Turns and Dead Stock and incorporate a GMROII goal. When the team is ready, I would add the Inbound Freight component.

If you need help getting started, please feel free to email me. Good luck.

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