Liquidating Dead Inventory – Vendor Returns
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I recently spent some time with a large distributor in Florida. The original reason for my visit was to assess the company's purchasing procedures and look for ways to improve the procurement process. After spending some time with the purchasing director, I happened to notice a report on his desk outlining the inventory turns for the last two years. Just like a good salesman, consultants learn to read upside down just in case there might be some important information residing on someone's desk. I asked about the report and indeed confirmed that it was a monthly turns history. Over the last 6 months, the turns had been dropping at an alarming rate. To give you a context of alarming, the turns had dropped from around 3.6 to 3.1 turns. Although I had not been originally hired to look at this trend specifically, it was apparent that this decline was causing more than its fair share of anxiety. This anxiety was compounded by the fact that my client, the purchasing manager, had just taken over the team 8 months ago. What had started out as a broad based task had now revealed a very specific goal: arrest the declining turns and reverse the trend.

Like many other indicators in our businesses, turns is simply a comparative ratio. In the numerator, we look at the cost of goods sold from stock sales for the past 12 months. We are diligent to make sure that we exclude any sales that may not be from our local stock inventory: direct ships, transfers to fill a back order, etc. Some software makes it difficult to filter out certain transactions, so we might have a little inflation in our numerator. But hey, we are benchmarking against ourselves. As long as we keep measuring it the same way, progress can be measured. While we are talking about benchmarking here, be sure to always measure against your own numbers. Be skeptical of the validity of "industry standards". I just mentioned a couple of ways that the ratio can be skewed. Besides, some of us tend to paint a slightly rosy picture when we respond to industry surveys. But I digress. The denominator of our turns ratio is the average inventory value. This is a far more stable value; but it can be slightly misleading due to the way our software calculates the average. By the way, the most pure way to find the average is to take 12 months of inventory values and divide by 12. Did I mention that consultants have a flare for stating the obvious; and then try to pass it off as something really profound?

In our situation, it was important to look at where we could make the most impact if the trend of declining turns was going to be corrected. Although the purchasing team does have some impact on our cost of goods sold number, through buying at a lower unit cost, the most logical area of focus was on the average inventory value side of our ratio. What are the factors that inflate our inventory? Overbuying is probably the largest contributor.

When we don't set our ordering controls properly, or base our purchases on gut feel, inventory inflation can often occur. Correcting the ordering controls will give us the greatest overall impact on our inventory value; but it takes a long time to realize significant gains. Sometimes, we will not achieve our inventory goals for 2 years. Since I have the patience of an average 4 year old taking a car trip, and most financial partners are not enthusiastic about waiting for a 2 year correction in a plummeting turn ratio, we need to find at a more immediate solution to our problem. If you want to make a quick correction in the average inventory value, attack the dead and slow moving inventory.

In the remainder of this article, I will focus my attention on one aspect of dead stock management: vendor returns. In order to set the context, I will explain a couple of steps that are required prior to liquidation of dead inventory. The most important thing to agree on is a time of death. As a company, we must have an agreed upon standard as to when something becomes dead in our system. The most common answer is no sales in 12 months. Some industries need to set their date at 3 months. But, for most hard goods distributors, 12 months is a good first start. Now this definition may produce a fairly significant number; but I challenge you to go one step further. Seek out those items that are nearly dead and add them to your list. Nearly dead items can be identified by using a hits report. A hits report simply tells us how many times a specific item appears on a sales order, regardless of quantity ordered, in a calendar year. If you need help creating a hits report, give me a call. You can eliminate most items with fewer than 4 annual hits and have virtually no adverse reactions with your customers. When you run this report for the first time, you will be amazed at the number of items that fall below 4 hits. Again, I recommend that you change these items to a non-stock status. There may be a couple of exceptions; but try to keep these to a minimum.

Now that we have identified this large lump of dollars, it's time to convert this inventory back into its original form: cash. Dead stock is still money; it's just old money. There are several ways to convert dead stock to cash; but, I would like to focus on the vendor return solution. Pre-negotiated vendor returns can put a large dent in our dead stock pile. In a previous article, I mentioned that it was important to establish return policies prior to taking on any vendor line. A little footwork up front can make our dead stock liquidation easier. Without prior agreements, sometimes vendors can be rather reluctant to accept a return of goods. As distributors, we seem to be reluctant to process returns to our vendor partners. We are great at taking returns from customers; but for some reason, we don't follow through with pushing the materials back up the supply chain. One of the problems I run into most often is that we do not actually know what the return policies are. A great homework assignment is to have your buyers research and clarify the manufacturer's stated return policies. You will be amazed at the opportunities we do not utilize.

Many distributors tend to get derailed by vendor return policies that require a restocking fee. Is a 20% restocking fee too much to surrender? Let me ask you this. How much have we lost by holding on to this inventory for a full calendar year? The average carrying cost for a distributor is about 25% annually. Each additional day that we hold on to an item adds to that carrying cost tally. Would I rather have 80 cents in my hand versus a diminishing dollar cluttering up my shelves? Every day and twice on Sunday.

With cash, I have the ability to invest in something that turns multiple times a year. I can recover my 20 cents in a few months.

In some cases, vendors give us a return allowance based on previous the year's purchases. Take advantage of this. Convert dead and nearly dead cash into turning inventory. At times this percentage can seem painfully low. This is where distributors have an opportunity to negotiate. Asking for a larger percentage will not always work. Sometimes we need to become creative. Offering a "one for one" return is a good way to start. This offer means that we are willing to cut a purchase order to the vendor for the same dollar value we wish to return. Consider offering a "1.5 for 1" return. Even a 2 for 1 return is acceptable. Remember, we are getting rid of inventory that occupies shelf space and ties up cash. By bringing in good saleable merchandise, we will recover our investment in a few months. There is a tendency for buyers to load up on their A items when putting together their offsetting orders. Be careful of this practice. You will wind up making it very difficult to make future target level purchases and find yourself running out of your B and C items. Spread the investment evenly over the entire line. During the negotiation, try asking for special dating. An extra 30 days is not uncommon.

In the case of my client, we determined that approximately 10% of his inventory was eligible for return using the manufacturer's stated policies. By simply processing these returns, we would not only arrest the fall, but his turn ratio would jump ½ a point. If he was able to go the extra mile and negotiate returns on the items with less than 4 hits, he could actually move up another ½ point once he bled through any additional offsetting order surpluses. It is very rare to see turns jump by a whole point in 12 months. The important thing to remember is that dead stock management needs to become a continual process. You will find the many manufacturers are more willing to process 4 smaller returns spread out over the year rather than one large return at year end. Here is another little trick. Put together your returns during the first month of the quarter, rather than the last.

Let's review the action steps:

1. Determine a company dead stock definition
2. Go the extra mile and identify the items close to death
3. Research and review the stated return policies of all vendor partners
4. Maximize your ability to return product under these rules
5. Negotiate offsetting orders for additional return privileges
6. Continually cycle out dead products on a quarterly basis

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