How to approach total inventory costs?

Inventory management and inventory strategy are key elements in operational practice. Inventory is a significant asset on the balance sheet of manufacturing companies. Depending on the industry sector, inventory can represent up to 20% to 30% of the total assets and inventory of packaging supplies often represents a sizeable portion of this value. Furthermore, the effectiveness of handling inventory is closely tied to the overall success of a manufacturer. There is a significant connection between financial performance and inventory performance.

Defining an optimal inventory strategy is complex. All direct and indirect costs related to holding inventory are very much underestimated. The common idea is that holding your own inventory is the only option and it is considered as a matter of course to structure the business.

The costs are (mostly) invisible or beyond awareness. In our view the attitude should be a more critical one.

How much does your inventory cost?

Most of the time, the true costs of inventory are underestimated and incomplete. Many companies consider the cost of inventory as "cost of capital" of the inventory asset. For example, a company with an average of € 500,000 in packaging inventory and an 8% funding costs (the blended rate of the return needed to pay stockholders, bondholders, and/or private parties to borrow money) sees a carrying cost of € 40,000 per year. But the actual costs are far greater than just this cost of capital. Consider the following costs associated with holding and handling this inventory:

Direct investment expenses

- The cost of capital invested in the inventory (as mentioned above)
- Insurance on the inventory
- Yearly loss due to obsolescence

Costs of housing the inventory

- Depreciation or rent on the building holding the inventory (or the part of the building used for inventory)
- Heat and utilities in the building holding the inventory
- Building maintenance
- Property insurance
- Cost of capital invested in the property

Handling of the inventory

- Depreciation or rent of internal transport equipment (e.g. forklifts)
- Direct operating costs of material-handling equipment (e.g. storage racks)
- Employee costs to receive, stack, and maintain materials
- Internal freight and transportation costs borne by the company

Administration and accounting costs

- Labour cost for stock accounts
- Management time spent on solving inventory issues

Costs of system failure

- Lost business and profits or impaired goodwill from (too) late delivery of materials due to disturbance in the supply chain.

When these additional costs are taken into account, the total cost of holding inventory can represent 25-30% of the inventory's book value. For the company with € 500,000 in packaging inventory, that translates into total holding costs of € 150,000 per year – about 4 times higher than the cost-of-capital calculation. The bill can climb even higher if improper inventory management is involved.

We experience that, in a Total Cost of Ownership (TCO) approach, avoiding these costs results in significant savings and is often the first step to optimize your packaging management.