

Releasing Value from Indirect Materials

Eberhard E. Scheuing, Ph.D., C.P.M., ISM Professor Emeritus
St. John's University
480/471-7393; Ebscheuing@aol.com

George Krauter, Consulting Vice President
Storeroom Solutions, Inc.
610/940-3800; george.krauter@storeroomsolutions.com

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Abstract. In all too many firms, indirect materials are treated haphazardly. They suffer from poor inventory records, multiple storage locations, uncoordinated purchasing, frequent out-of-stock conditions, and lack of managerial attention. This paper presents a checklist for diagnosing current ills, offers suggestions for overcoming them, and outlines a systematic, integrated approach that releases the hidden value from a firm's indirect materials function by reducing cost and increasing turnover as well as service performance. Session participants will take away a comprehensive framework for assessing their firms' MRO functions and streamlining their performance.

The Opportunity. Most firms pay a great deal of attention to managing the quality and cost of the direct materials that are essential to the final products they offer in the marketplace. They worry about their color, appearance, flexibility, durability, safety, and a variety of other physical aspects and dimensions. Because these competitive characteristics receive considerable attention, they are typically managed very successfully.

In contrast, indirect materials are often treated as corporate stepchildren. Maintenance, repair, and operating supplies are usually considered necessary evils and unglamorous assignments. Comprising a motley assortment of spare parts, fasteners, and cleaning and office supplies, indirect materials are often given short shrift in supply management groups and individual career development plans.

This traditional benign neglect spells considerable opportunity in many organizational environments. Even just a first cursory glance may reveal substantial potential for improvement by eliminating duplicate, obsolete, or 'squirrel' inventories. And it may point out the promise of professional management of a long-ignored element of organizational performance.

Assessing Your Current Management of Indirect Materials. Traditional indirect materials management approaches tend to be quite inefficient and ineffective because

- materials are often bought, stored, and used one transaction at a time;
- vendors are kept at arm's length, receiving and responding to RFIs, RFQs, RFPs, and P.O.s;
- the supply management function responds to requests, rather than forecasts;
- few, if any, strategic sourcing initiatives concern themselves with indirect materials;

- storage, record keeping, and inventory management are frequently haphazard, leading to emergency purchases and overnight deliveries;
- information about inventories at multiple storage locations is not pooled, and hidden inventories exist at user sites; and
- obsolescence, shelf life, and theft prevention are not carefully managed.

The following easy-to-use checklist enables an organization to assess the productivity of its indirect materials operation.

Indirect Materials Productivity Checklist

- | | | |
|------------------------------|-----------------------------|--|
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 1. Does your storeroom inventory turn less than twice a year? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 2. Does your site use multiple brands of equivalent products? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 3. Do multiple locations at your site contain the same items? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 4. Is the same part stocked under different stock numbers? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 5. Do uncontrolled sub-stocks exist in using departments? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 6. Do you buy from more than 50 MRO suppliers? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 7. Do you control MRO inventory with a manual system? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 8. Does your company employ more than 2 storeroom attendants for each \$ 750,000 in MRO purchases? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 9. Does your system require a manual 3-way match between purchase order, receiving report, and supplier invoice? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 10. Do suppliers invoice each MRO shipment? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 11. Is the lead time from requisition to storeroom more than one day? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 12. Are 10% or more of the items in your storeroom(s) obsolete? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 12. If MRO inventory is computer-controlled, does the system create purchase orders for stock replenishment? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 13. Is the cost per purchase order believed to be \$75.00 or more? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 14. Do min/max quantities have questionable controls and adjustments? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 15. Is there opportunity for savings via productivity programs? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 16. Can existing suppliers do more to focus attention on your cost recovery needs? |
| <input type="checkbox"/> Yes | <input type="checkbox"/> No | 17. Is the total cost of MRO stores recognized as a necessary unrecoverable cost? |

Any organization with four or more 'yes' answers to this checklist could release considerable value by reorganizing its storeroom operations.

To recognize the need to change, the MRO consumer must understand the barriers to cost reduction that exist in the traditional supply chain. These barriers represent duplications in the chain and are both objective and subjective in nature; they do not allow the achievement of an optimum cost solution when parts are consumed.

Alternative Approaches. A number of leading edge organizations have successfully taken on the indirect materials challenge and developed comprehensive, sophisticated solutions that streamline their indirect materials operations and enable them to outperform the competition by releasing funds, personnel, and space that were unnecessarily tied up in excessive, outdated, and uncontrolled indirect materials operations.

A *first solution*, dubbed here the *Streamlined Operations* approach involves:

- consolidating indirect materials inventories in one central location per facility,
- using a computerized system to manage and control storeroom inventories,
- professionalizing storeroom staff, and
- asking suppliers to manage inventories of their parts and/or provide consigned inventories.

The benefits include greater efficiency, improved performance, increased supplier involvement, and better control. But there are also disadvantages. They include higher expenses for personnel and systems and the need to monitor and manage employees and/or inventories from multiple suppliers as well as related information security issues.

Many large companies believe that by utilizing ERP systems and leveraging their perceived purchasing power they can achieve a streamlined operation. In the real world, however, the existence of ERP systems does not achieve inventory recoveries and spend reductions because, after all, “we can never be out of stock in a needed item.” Also, the existence of corporate contracts does not by itself achieve optimum measurable price reductions due to lack of internal compliance, procurement cards, and the frequency of locally executed spot buys.

Companies that employ various purchasing methods to control and reduce purchase costs report achievements based upon last price paid vs quoted pricing from multiple suppliers. The use of EDI and E-procurement systems can produce savings and cut paper processing costs. These systems also enable requisitioners with budgets to purchase from approved sources and non-approved sources via computer-established authority.

But all of these approaches, even when employed at optimum, place the recovery of other MRO costs on the shoulders of plant personnel. Reduction of these costs does not occur because of the concept that the storeroom will always be an unrecoverable cost and, therefore, commands no further investment by plant management. The cost continues to exist.

Many companies make decisions based on inaccurate MRO information regarding inventory, purchases for inventory, one-time spot buys, transaction burden, etc. With inaccurate data, it becomes difficult, if not impossible to establish a performance baseline and measure improvement. Plant management concentrates on the pressures of production and profitability. The condition continues.

Some corporate materials groups feel that an on-site supplier is in conflict with the goals of the corporate effort. They state that they provide optimum pricing programs and ERP systems that are the tools the site can use to reduce all MRO costs. Although improvements are made, recoverable costs remain.

A *second* type of *solution*, which we call the *Lean Distribution* approach, involves selecting a firm that specializes in providing on-site storeroom management services. These firms offer a comprehensive, cost-effective solution to the indirect materials dilemma.

Such firms:

- know how to implement effective indirect materials programs;
- know where the pitfalls are;
- have systematic, proven approaches to saving money, recovering inventory, improving performance, and simplifying processes;
- invest in research efforts, systems upgrades, and operational linkages;
- obtain supplier discounts due to their role as intermediaries and the larger volume they bring to suppliers from multiple customers;
- provide a systems audit trail that passes savings on to their clients;
- continuously improve processes, productivity, cost, quality, and competitiveness;
- demonstrate strong commitment and prompt problem and emergency response; and
- dramatically improve service levels as well as process transparency.

When the goals of corporate management mesh with the total cost reduction opportunities at the site, the on-site supplier becomes the vehicle to satisfy the vision of all disciplines and to eliminate barriers of distribution.

Selecting a Solution Provider. A prospective on-site storeroom solution provider should satisfy the following requirements:

- *Focus:* Their sole source of revenues should be on-site programs.
- *Recognition:* Their position in the MRO supply chain should allow for best buy sourcing without franchise restrictions.
- *Transparency:* They should be willing to disclose their cost of goods per SKU net of rebates and be willing to provide audit access.
- *State-of-the-art Systems:* They should offer systems capabilities that include:
 - compatibility with your existing system(s);
 - improved information flow;
 - ability to measure and report performance;
 - meeting Sarbanes-Oxley requirements; and
 - flexibility to meet your specific needs.
- *Commitment to Excellence:* Senior management must demonstrate appropriate experience and a convincing track record as well as:
 - well-trained on-site personnel plus support and back-up;
 - investments in systems improvements;
 - ability to fund on-site investments; and
 - stock ownership.

Value Release Benefits. Although all organizations use indirect materials, they are all too frequently treated as a necessary evil rather than a source of agility and responsiveness. The benign neglect afforded this function masks a substantial opportunity to save money and improve performance. Taking a thorough, uncompromising look at an organization's indirect materials operation and selecting an approach to substantially upgrade its procedures and results will yield some or all of the following benefits:

- consolidation of multiple and rogue inventories;
- streamlined system to manage ordering, receiving, releasing, and monitoring inventories;
- professionalization of storeroom personnel;
- improved control and transparency;
- reduced lead times and inventories;
- reduced waste and cost;
- standardization of parts;
- combining purchasing power of large and small plants; and
- improved responsiveness and performance.