



Distribution Center MANAGEMENT

July 2007

Managing people, materials and costs in the warehouse or DC

From the Golden Zone

Lost material is costing your DC a lot more than you think

By Jon Schreibfeder

If one of your employees walks past an item laying in the middle of a warehouse aisle, do they pick it up and put it in its proper location? Do they pretend not to see it? Do they feel they are too busy to deal with it? Do they kick it out of the way?

The answers to these questions provide a good indication of what your employees think about your inventory. For any distribution center to be successful, its employees have to see the direct relationship between inventory and their paychecks. After all, inventory is just cash in a different form. Furthermore, inventory must be transformed back into cash (through sales) for the company to have the money to pay its employees. A business cannot be successful (or perhaps even survive) unless all of its employees understand this relationship.

You can see if your employees understand this concept by giving them a little test at your next team meeting. Let them consider the following scenario:

Joe works in your warehouse. He's never been what you call neat. His motto is: "Serve the customer quick, and don't let anything get in the way." Joe doesn't think twice about flinging boxes aside to get at items he wants. The path of destruction he leaves in his wake has earned Joe the well-deserved nickname "The Tornado."

It's probably not surprising that Joe occasionally (once a week or so) breaks something. And it probably won't shock you to learn that some of the material that Joe flings out of the way is sometimes never seen again. In fact, Joe loses or breaks on average \$100 worth of material every week. How does the company make up for this loss?

Many people would respond that the company would have to sell an additional \$100 worth of material to cover Joe's losses. Some might also argue that the \$100 cost may be worth the speedy service Joe provides the customers. But in reality, both these assumptions are wrong.

Material losses, whether from theft, breakage, or misplacing stock, must be paid for with profit dollars. If a distributor's gross margin is 20 percent, that means it has 20 cents available from every dollar of sales to pay for expenses and hopefully have some left over (i.e., net profits). The replacement material has to be paid for out of these 20 cents — not the full dollar.

Therefore, to make up for Joe's mistakes, the company doesn't need \$100 in new sales, it actually needs \$500. That's because 20 percent of \$500 is \$100.

$$\$500 \times 20\% = \$100$$

When management doesn't provide workers with a true picture of the company's profitability, employees often believe profits are much higher than they actually are.

This article was reprinted from the July 2007 issue of *Distribution Center Management*.

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Now, if we change this equation around slightly, we get a calculation that illustrates the true cost of lost merchandise:

$$\frac{\text{Value of Lost/Broken Material}}{\text{Gross Margin Percentage}} = \frac{\text{Additional Sales Needed to Make Up for Lost/Broken Material}}{\text{Gross Margin Percentage}}$$

So, if you divide the value of the lost material by your company's gross margin percentage, you get the amount of additional sales you need to generate to make up for the loss. Let's apply this formula to our example:

$$\frac{\$100}{.20} = \$500$$

This is what we call an "acid-stomach" illustration. That's because after determining the real cost of lost and damaged material, many people will probably be reaching for the bicarbonate of soda to relieve their heartburn. And this calculation doesn't take into account the other costs a business incurs when inventory is lost. These include:

- Additional expenses from ordering emergency shipments and "fighting fires",
- Labor wasted searching for missing material in the warehouse, and
- Disappointed customers who were promised material that exists in the computer system but can't be found.

One way to make sure employees can see and

appreciate the true cost of lost and damaged inventory is to post the figures weekly, like this:

Week of	August 2	August 9	August 16	August 23
Missing	\$310	\$250	\$264	\$219
Damaged	\$224	\$184	\$172	\$158
Total	\$534	\$434	\$436	\$377
Needed Sales	\$2,670	\$2,170	\$2,180	\$1,885

Some managers will read this and say: "There's no way I'm going to provide information about our net profits to our employees. After all, that's confidential information."

If you feel this way, please reconsider. We've found that when management doesn't provide workers with a true picture of the company's profitability, employees often believe profits are much higher than they actually are.

You never want employees to believe that it's okay to break, give away, or steal material because "the company can afford it." And the best way to dispel myths of inflated profits is to present your company's actual profitability to all employees.

When a warehouse person kicks a box out of the way, he or she must understand that they're kicking the source of funds for their paycheck.

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