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TOPIC: The comparative study of consignment and vendor managed inventory with special reference of cost structure

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Abstract
The rapid development of the Internet has dramatically changed the traditional definitions of manufacturer, suppliers and customers. Traditional way of business has gone through changes and now a day Vendor Managed Inventory (VMI) and consignment serve as a centralized link between suppliers and customers that enables faster and less complex transactions. This research is focused to compare the performance of a VMI supply chain with a consignment chain and the aim of this paper is evaluate the impact of these two alternative structures on the cost structure and inventory of the business.
Keywords: consignment, vendor managed inventory, cost structure, inventory

Introduction

Earlier the distribution chain of the products so long that the manufacturer lie at one edge and consumer on other edge and lots of middlemen between them but now the scenario has change. Traditional method change into consignment and vendor managed inventory. You're beginning to see the pattern: your customers want to increase their profits at your expense. Instead of paying for product within 30 days of delivery, the two who want a consignment program want to delay payment until after using or selling your product. The third wants to go one step further - they want you to plan their inventory! It's obvious how these moves will benefit your customers, but is there any benefit for you? wal-mart, e-bay all these new ideas of business occupy a very big space in market place and build a very good image by using consignment/VMI without taking much risk like as manufacturer and earn huge profit and fulfill there motive.

Now what is vendor managed inventory and consignment

Meaning of consignment

The word consignment comes from the French consigner, meaning "to hand over or transmit", originally from the Latin consignare "to affix a seal", as was done with official documents just before being sent

Consignment is the act of consigning, which is placing any material in the hand of another, but retaining ownership until the goods are sold or person is transferred. When a trader sell goods directly to consumer, whether they are in his home country or overseas, these are ordinary sales. However, a trader may send goods to an agent to sell them for him. these goods are said to be end on consignment. Consignment may be done for shipping, transfer of goods to auction, or for sale in a store (i.e., a consignment shop). In case of consignment goods are sent to the agent for the purpose of sale. The agent sells the goods on behalf of the sender, according to his instructions. The sender of goods is known as consignor and the agent is known as the consignee.

For example

suppose Mr.A consigns a laptops to Mr. B, who offers to sell it for him at his store. Mr. A (the consignor) and Mr. B (the consignee) have not exchanged any money no purchase was transacted, and Mr. A still owns the laptop. One day a customer purchases the laptop at Mr. B's store. Mr. B gives the proceeds to Mr. A, less an agreed-upon consignment fee for Mr. B's service as the seller.

In procurement on a consignment basis, your vendor delivers certain materials to you that you handle in the consignment stock of your business. The consignment stock remains the property of the vendor until you remove material from the consignment stores. Once you have withdrawn materials, you will have liabilities towards the vendor that you need to pay in periodic settlements (for example, monthly). You and your vendor can agree on a time period after which you have to transfer unused consignment material to your own stock.

Meaning of vendor managed inventory

Vendor-managed inventory **(VMI)** is a family of business models in which the buyer of a product (business) provides certain information to a vendor (supply chain) supplier of that product and the supplier takes full responsibility for maintaining an agreed inventory of the material, usually at the buyer's consumption location (usually a store). A third-party logistics provider can also be involved to make sure that the buyer has the required level of inventory by adjusting the demand and supply gaps.

Vendor-Managed Inventory (VMI) is a planning and management system that is not directly tied to inventory ownership. Under VMI, instead of the customer monitoring its sales and inventory for the purpose of triggering replenishment orders, the vendor assumes responsibility for these activities. In the past, many suppliers operated vendor-stocking programs where a representative visited a customer a few times a month and restocked their supplies to an agreed-upon level. Popularized by Wal-Mart, VMI replaces these visits with information gathered from cash registers and transmitted directly to a supplier's computer system via Electronic Data Interchange (EDI). Now, suppliers can monitor sales of their products and decide when to initiate the resupply procedure. This is not an inexpensive proposition for suppliers. Investments must be made in new systems, software, and employee training. Which brings us back to the question: Is there a payoff? Consumers benefit from knowledgeable store staff who are in frequent and familiar contact with manufacturer (vendor) representatives when parts or service are required. Store staff have good knowledge of most product lines offered by the entire range of vendors. They can help the consumer choose from competing products for items most suited to them and offer service support being offered by the store. As a symbiotic relationship, VMI makes it less likely that a business will unintentionally become out of stock of a good and reduces inventory in the supply chain. Furthermore, vendor (supplier) representatives in a store benefit the vendor by ensuring the product is properly displayed and store staff are familiar with the features of the product line, all the while helping to clean and organize their product lines for the store.

Features of consignment are:

1) The relation between the two parties is that of consignor and consignee and not that of buyer and seller
2) The consignor is entitled to receive all the expenses in connection with consignment
3) The consignee is not responsible for damage of goods during transport or any other procedure
4) Goods are sold at the risk of consignor. The profit or loss belongs to consignor only
5) A consignor who consigns goods to a consignee transfers possession but not ownership of the goods to the consignee. The consignor retains title to the goods. The consignee takes possession of the goods subject to a trust. If the consignee converts the goods to a use not contemplated in the consignment agreement, for example selling them and keeping the proceeds of the sale for himself, then the consignee commits the crime of embezzlement.
6) The trader send goods to the agent.the goods do not belong to the agent: his job is to sell them for the trader. The goods are owned by the trader until they are sold. The trader sendi8ng the goods is called the consignor. The agent is called the consignee.
7) The agent will store goods until they are sold by him. He will have to pay some expenses, but these will later be refunded by the trader.
8) The agent will receive a commission from the trader for his work.
9) The agent will collect the money from the customers to whom he sells the goods. He will pay this over to the trader after deducting his expenses and commission. The statement from the agent to the trader showing this is known as the account sales.

Benefits of VMI

There are some advantages of VMI are as follow:

1. Improved customer service. By receiving timely information directly from cash registers, suppliers can better respond to customers' inventory needs in terms of both quantity and location.
2. Reduced demand uncertainty. By constantly monitoring customers' inventory and demand stream, the number of large, unexpected customer orders will dwindle, or disappear altogether.

3. Reduced inventory requirements. By knowing exactly how much inventory the customer is carrying, a supplier's own inventory requirements are reduced since the need for excess stock to buffer against uncertainty is reduced or eliminated.
4. Reduced costs. To mitigate the up-front costs that VMI demands, Fox suggests that manufacturers reduce costs by reengineering and merging their order fulfillment and Distribution Center replenishment activities.

While these are all potential benefits of VMI·

How VMI is more effective as compare to consignment & there respective effect on cost structure.

Traditionally, most manufacturing and distribution operations determine what to sell and how much to sell by way of forecast. Countless hours are spent developing, massaging, and tweaking forecasts – only to have them turn out to be dead wrong. Why? Because a forecast is nothing more than "an estimate of future demand" . And, unlike most of us cannot predict the future! Under VMI, instead of a supplier forecasting what customers will buy - which means guessing at

1) What customers are selling,
2) Their inventory positions, and
3) Their inventory strategies

A supplier works with real sales and inventory data first hand. Because the supplier is effectively handling their customers' materials management function, customer inventory strategies are revealed. Soon, the supplier finds that it can provide input on the timing of promotions and safety stock strategies such that it can easily accommodate changes in demand. This reduction in demand uncertainty enables suppliers to operate at higher service levels with lower inventories. Clearly, these are benefits coveted by any and all suppliers.

Such are the benefits of VMI - what about consignment? Isn't that the same as giving a customer an interest-free loan? Maybe. Before passing judgment, let's take a look at how most companies do business and examine the components of inventory carrying cost.

Most manufacturing and distribution companies, with the exception of make-to-order firms like Boeing, hold inventory for customers in the form of finished goods. This buffers manufacturers against fluctuations in demand. However, this stock of finished goods doesn't come free.

There is an estimation of how the cost structure effect.

- annual inventory carrying costs for most companies range from 20 to 36 percent.
- Cost of Capital10 – 15%
- Storage & Warehouse Space2 – 5%
- Obsolescence & Shrinkage4 – 6%
- Insurance1 – 5%
- Material Handling1 – 2%
- Taxes2 – 3%
- Total Annual Inventory Carrying Costs20 – 36%

Let's examine the impact of consignment on two businesses that both have annual carrying costs of 36 percent.

Company A holds finished goods inventory and Company B has just decided to provide it on consignment. Company A is responsible for capital, storage, handling, and all other costs listed above. Company B is responsible for providing the capital, and as owner of the goods, is responsible for paying taxes on what isn't sold. However, under consignment, Company B is no longer responsible for storage or material handling. In addition, as with most consignment agreements, Company B's customers now have responsibility for any damage or disappearance of goods on their properties. Thus, Company B has transferred its cost of insurance and "shrinkage." Finally, by closely tracking the use of product and acting swiftly on slow-moving items, Company B can minimize or completely eliminate product obsolescence.

A quick review of cost components demonstrates that by implementing a consignment program, Company B can reduce its annual inventory carrying costs from 36 percent to 18 percent (cost of capital + taxes) in a consignment program, a reduction of 50 percent! However, if too many dollars are put into customers' warehouses on consignment, the negative impact on cash flow could leave a supplier asset rich and cash poor, a condition that could lead to bankruptcy.

Both are equivalent good but certain things need to be care

- A well-designed consignment agreement.
- Keys Points in Any Consignment Agreement explained in advance

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- When negotiating a consignment agreement, it is critical to consider the elements of cost, responsibility, and time.
  The key elements are as follows:

a) Level of consigned inventory. A customer would prefer to hold a large amount of consigned inventory, viewing it as a cheap way of buffering against demand uncertainty. The supplier, however, must determine the level at which it can provide goods profitably. Negotiating a set number of weeks of supply will meet the needs of both parties. If the customer sells/uses $5.2 million dollars a year and the agreement calls for ten weeks of supply, both parties know that $520,000 is the consigned level. The supplier can now budget for the capital required and the potential taxes involved in supporting the inventory. Adjustments can also be made in its cash flow projections. This arrangement also provides the customer with an incentive for increasing sales of the suppliers' products since an increase in sales translates into an increase in consigned inventory.

b) Responsibility for slow-moving inventory. Another key element in a successful consignment relationship is to keep the inventory moving. Developing inventory turn goals, by individual product or by product group, can uncover slow-moving items that are inappropriate for consignment. During negotiations, it is important to determine which party will monitor inventory turnover and how slow moving goods will be handled, whether they will be returned to the supplier or purchased by the customer and removed from the consigned inventory.

c) Responsibility for damaged or lost inventory. Another critical factor to address during negotiations is the disposition of stolen or damaged inventory. It is customary for the customer to assume complete responsibility for all consigned inventories - lost, stolen, or damaged - on its premises. A periodic physical inventory needs to be established to account for all consigned inventories.

By following these guidelines, a successful – and profitable – consignment relationship can be established that benefits both parties.

Consignment is when a shop sells goods for an owner. The owner keeps ownership of his item until it sells, if it sells. As the owner, you'd pay a small fee to the shop as compensation for them selling your item.

Consignment v/s VMI

- Consignment arrangements typically are in effect for a set period of time. After this time, the goods are returned to their owner. Selling on consignment is a great option for individuals or businesses that do not have a brick-and-mortar presence, although consignment arrangements can also exist in cyberspace. To a certain degree, online companies like eBay are consignment shops, because, for a percentage of the sale, they offer people a marketplace to exhibit and sell their wares. For example, you consign a children's bicycle for $20. Generally, when they sell your bicycle, they take their 50% or $10. You receive $10. If the bicycle doesn't sell, then you take your items home for no charge. (Some places do charge a small "activation" or consignment fee.)

- One of the keys to making VMI work is shared risk. In some cases, if the inventory does not sell, the vendor (supplier) will repurchase the product from the buyer (retailer). In other cases, the product may be in the possession of the retailer but is not owned by the retailer until the sale takes place, meaning that the retailer simply houses (and assists with the sale of) the product in exchange for a predetermined commission or profit (sometimes referred to as consignment stock). A special form of this commission business is scan-based trading whereas VMI is usually applied but not mandatory to be used. This is one of the successful business models used by Wal-Mart and many other big box retailers. Oil companies often use technology to manage the gasoline inventories at the service stations that they supply (see Petrol soft Corporation). Home Depot uses the technique with larger suppliers of manufactured goods. VMI helps foster a closer understanding between the supplier and manufacturer by using Electronic Data Interchange formats, EDI software and statistical methodologies to forecast and maintain correct inventory in the supply chain.

- Improved customer retention. Once a VMI system is developed and installed, it becomes extremely difficult and costly for a customer to change suppliers. But in consignment no such problem face you can change easily .
- Reduced reliance on forecasting. With customers for whom a supplier runs VMI programs, the need to forecast their demand is eliminated VMI - Binding Customers to Suppliers. But in case of consignment there is a strong need to forecast demand.
- Once a VMI system is established, a customer has effectively outsourced its material management function to its supplier. After a period of time, the customer will no longer have the resources to perform this role in-house, making him more dependent upon the supplier. In addition, developing a VMI system entails major costs to the customer. His information services department has to spend time ensuring a smooth transfer of data to the supplier. And his materials management organization has to spend a significant amount of time making sure that the chosen supplier will perform, and beyond that, ironing out a myriad of details ranging from what will trigger a reorder to how returns will be handled. Once all this work is done, nothing short of a major breach in a supplier's performance will prompt the customer to search for a new supplier. With VMI, customer/supplier partnerships are not only encouraged, they are cemented. But no such facilities with that of the consignment as no such strong bond of relationship between vendor and buyer.

Conclusions

We have examined some of the benefits of VMI and features of consignment from a supplier's perspective. Indeed, there are benefits to both approaches, as well as costs and risk also involve in both chains By understanding and managing the costs, and controlling the risks through careful negotiations, one can make both consignment and VMI work not only for the customer, but for the supplier as well.

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