***Managing working capital: Raw materials***

Managing the raw materials element of working capital is about ensuring that our stocks of materials are as low as possible, whilst also ensuring we get good prices, and ensuring a reliable supply of materials.

Of course, these three aims are contradictory. How do we get good bulk discounts, without holding high levels of stock? And if we run stocks too low, we’ll repeatedly have to halt production whilst we wait for deliveries to arrive.

So it’s a compromise – like much else in business! Our aim is to find the best compromise that balances all our needs. But this article has a few thoughts to guide us.

**Just in time delivery and buffer stocks**

Just in Time delivery (JIT) doesn’t mean each component is delivered just as it’s needed on the production line. It will include a safety margin; a buffer stock. This may be a day’s worth of stock (or less, or more according to the business’s needs) to protect the business against a late, incomplete or faulty delivery. Very rigorous quality checks and long lead times may extend this to weeks or months in some extreme cases.

**Predicting demand and production**

Stock levels can’t be minimised without a reliable prediction of customer demand and production. If customer demand is highly unpredictable and has to be satisfied immediately (as in a restaurant, for example), a larger stock of materials will need to be held. With perishable raw materials (the restaurant kitchen again) this will lead to higher wastage costs as well as more cash tied up in working capital.

The manager responsible for predicting usage may tell you it’s too difficult to do this accurately. Are they telling the truth, or opting for an easy life? It’s very rare that usage can’t be predicted at all, even though some businesses may be more predictable than others.

**Calling down bulk orders**

We want to have the cost advantage of bulk discounts, but without the working capital problems of high stocks. So can we place a bulk order, but call it down (and be invoiced for it) as we need it? We’re passing the working capital problem to our supplier: our stock of raw materials becomes their stock of finished goods. So they may have an issue with this: it depends how much thought they’ve given to working capital management.

**The cost of placing orders and receiving deliveries**

Every order takes time (and therefore money) to be placed, and every delivery has to be checked in. So we don’t want daily deliveries of everything. We need to consider the impact of our actions on our profitability, and on our working capital and cashflow.

**The cost of holding stock**

Not only do high stock levels mean too much cash tied up in working capital, it also increases warehousing costs.

The more stock we hold, the bigger the warehouse, and the higher the cost of lighting and heating it. The longer we hold stock for, the higher the chance of it getting damaged, going out of date, or becoming obsolete. The fuller the warehouse, the more we have to keep moving things to get to something else.

So reducing stock levels can boost our profit levels as well as helping cashflow.

**The dust test**

Walk around your stockroom, and see how often you can write in the dust that’s gathered on the piles of stock. If you can, that line of stock has probably been sitting around for too long.

(Don’t try this is in a sawmill: it won’t tell you anything!)

**In summary…**

It will take time to reduce stock levels, but every reduction means that more money is in the bank account rather than in the warehouse. As the biggest cause of business failure is cashflow problems, this is important.