Consignment Inventory: What is it and When Does It Make Sense to Use It.
By Dave Piasecki

Let's start with a simple definition: **Consignment Inventory is inventory that is in the possession of the customer, but is still owned by the supplier.**

In other words, the supplier places some of his inventory in his customer's possession (in their store or warehouse) and allows them to sell or consume directly from his stock. The customer purchases the inventory only after he has resold or consumed it.

The key benefit to the customer should be obvious; he does not have to tie up his capital in inventory. This does not mean that there are no inventory carrying costs for the customer; he does still incur costs related to storing and managing the inventory. So what's in it for the supplier? This is where the benefits may not be so obvious—or may not even exist. Let's start with a classic consignment model that has significant benefits for the supplier.

**Where Consignment Works Best.**

A supplier has a product or group of products that he believes will sell if he can get them in front of end-users. The trick is that getting them in front of end-users means getting them stocked in retail establishments. Retailers are hesitant to stock the product because they do not have the same level of confidence in it as the supplier, they do not want to invest the money and risk getting stuck with something that may not sell. Because the supplier realizes in-store exposure is critical to getting his products sold, he offers to stock his product in their stores. This creates a condition of shared risk whereby the supplier risks the capital investment associated with the inventory while the customer risks dedicating retail space to the product. This also creates a condition of shared benefit because neither the supplier nor the customer will benefit until the product is sold to an end-user. This shared-risk/shared-benefit condition will often be enough to convince a customer to stock the product.

For a more specific example, consider a bicycle manufacturer that produces a wide range of bicycles ranging in price from a couple hundred dollars to several thousand dollars. He has customers (local independent bicycle shops) that stock his low-to-mid-priced models but are hesitant to stock the more expensive bikes because they do not have the confidence that their customers are willing to pay that much for a bike. And, if they do get a customer that wants a high-end bike, they could always special order it for them. The bicycle manufacturer strongly believes that getting his high-end bikes in the shops where customers can see and touch them is critical in driving up sales for these models as well as helping to promote his brand which ultimately drives up sales for the lower cost models. The solution? Well I think you can take it from here.

I consider this the classic consignment model because it is the best-case scenario for applying the consignment inventory model. It works well for:

- New and unproven products
- The introduction of existing product lines into new sales channels.
- Very expensive products where sales are questionable.

The key to all these examples is the combination of a high-degree of demand uncertainty from the customer's point of view, and a high degree of confidence in the sales potential from the supplier's point of view.

The consignment inventory model can also be effective with service parts for critical equipment where the customer would not stock certain service parts due to budget constraints or demand uncertainty. In this situation, consignment inventory allows the supplier to provide a higher service level (by having the parts immediately available), save expedited freight costs, and ensure the customer does not procure a replacement part from a competitor.

**Not so Good.**

So where is consignment inventory less effective or even counterproductive? I don't recommend using consignment inventory as a localized cost-cutting tactic. This is where a big customer decides that he is going to pressure his suppliers into providing consignment inventory to eliminate his investment in
inventory. In these situations, the customer was probably already stocking the product and is simply using his leverage over the supplier to reduce his costs. While this may reduce the customer’s costs, it is actually just moving these costs from the customer to the supplier. In addition, consignment inventory will almost always add costs to the supply chain because there are additional costs associated with managing the consignment process. So in the end, the supply chain has to absorb more costs without any meaningful benefits.

**Note:** There is a potential side benefit to consignment inventory in that some shared information that results from the consignment process could be useful to the supplier in his inventory management. Unfortunately, this information is rarely integrated into their planning systems. Some of this may be due to laziness or negligence on the part of the supplier, but there are also valid reasons why this information is not utilized. The primary one being that it requires very different system logic to utilize customer inventory levels in your planning processes; if consignment inventory is only a small part of your business, it may not be cost-effective to add the complexity to your planning systems to utilize this limited information.

**Many faces of consignment inventory.**

Below are some examples of the variety of approaches to consignment.

- **Consignment transfer of ownership models.**
  - Pay as sold (real-time)
  - Pay as sold during a pre-defined period.
  - Ownership changes after a pre-defined period.
  - Order to order consignment (when next consignment order is placed, previous is billed).

- Various system tracking models. (supplier)
  - Transferred to consignment Warehouse/facility.
  - Purely an accounting process (rather than moving dollars to payables, it transfers it to a consignment account).
  - Sometimes overall quantities are tracked, sometimes quantities are tied to original consignment order.

- Various system tracking models. (Customer)
  - Received into consignment Warehouse/facility.
  - Purely an accounting process (create an offsetting consignment inventory account)
  - Sometimes overall quantities are tracked, sometimes quantities are tied to original consignment order.
  - Transitioning can be a problem. (how you deal with owned and consigned quantities of the same item)

**Agreement Issues**

Both parties need to clearly understand the terms.

- Real-time sales or period-end sales.
- Time limit (must be purchased or returned within specified period).
- What is the freight policy?
- What is the return policy?
- Who holds responsibility for damage or loss while in customer’s possession?
- What are the Insurance implications?
- Exactly how and when is data exchanged? What data is exchanged?
- How are miscellaneous transactions processed?
  - Cycle count adjustments,
  - Customer Returns (does a return initiate a credit from the supplier?)
Most systems don’t handle consignment inventory very well.
The nature of consignment inventory is that “change of ownership” is unrelated to the shipment/receipt processes. This is contrary to the basic design of most inventory/accounting system’s transactional processes. Because of this, most inventory system’s do not handle consignment inventory very well.
This forces many businesses to manage consignment inventory with manual off-line processes (sending reports back and forth, maintaining data in spreadsheets, etc). Not only is this time consuming, but it also creates many opportunities for errors because the additional transactions necessary for consignment inventory can get rather complicated and are highly dependant on accurate information sharing. If this process is not monitored closely, you can end up in a situation where reconciling your consignment inventory becomes a nightmare.
If consignment inventory is a significant part of your business you need to look for software that focuses on consignment inventory or look into modifying your current system to add this functionality.

Other Considerations
- Ideally, Consignment inventory should be invisible to most workers (warehouse, manufacturing, sales order processing). If these people need to process consignment inventory transactions differently from non-consignment transactions, you can expect to have problems. These problems can range from minor annoyances and delays in processing transactions, to very serious data integrity issues when transactions are improperly executed.
- When demand is reasonably known and stable, consignment inventory is not recommended. If a customer is pressuring consignment to reduce his costs, you may be better off offering longer payment terms rather than consignment inventory. This should achieve the same objective without creating the added burden of managing consignment inventory. Just be careful that you don’t end up giving him consignment inventory AND longer payment terms.
- What is the relationship between consignment inventory and vendor-managed inventory? Well, that sounds like another article.

It's very important to realize that consignment inventory will almost always add costs to the supply chain. Use it only when it provides benefits that surpass these added costs.

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