LEC006 Inventory Management I

VG441 SS2021

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Fundamental Tradeoff

Overstock

Understock

Inventory Turnover

$$\text{Inventory Turnover Ratio Formula} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Some Terminologies

- Demand rate
- Lead time
- Quantity discount
- Review type
- Planning horizon
- Stockout type
- Service levels
- Fixed costs
- Perishability
- ……

Deterministic Inventory

INPUT:

- Constant deterministic demand rate λ
- No stockout is allowed
- Zero lead time
- Fixed cost K per order
- Purchase cost c per unit
- Inventory hold cost h per unit per unit of time

OUTPUT:

The optimal ordering strategy

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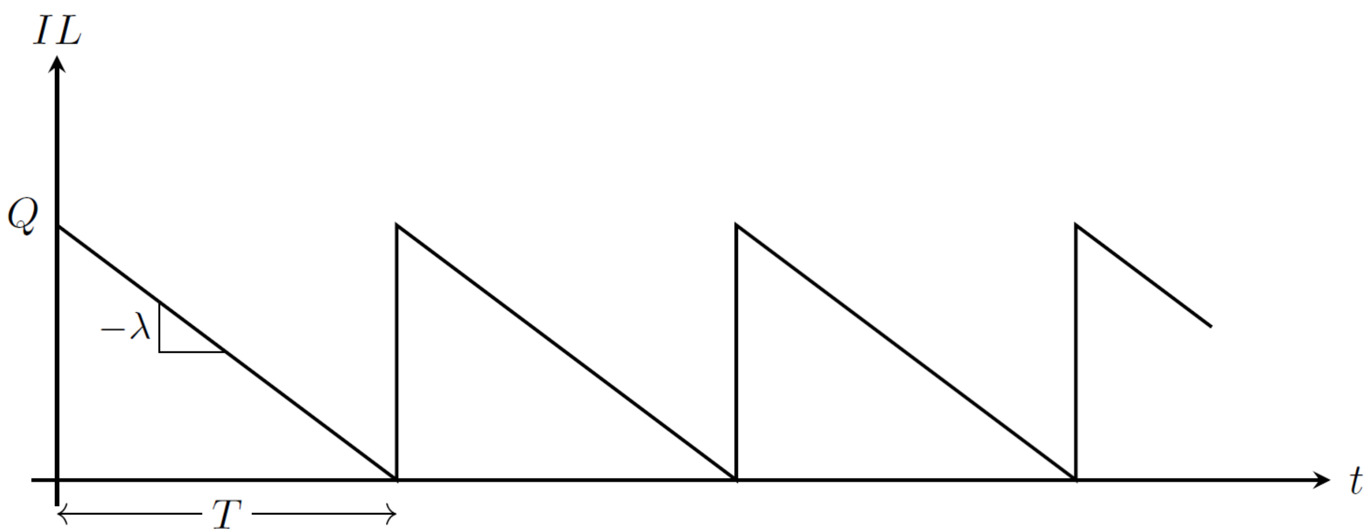
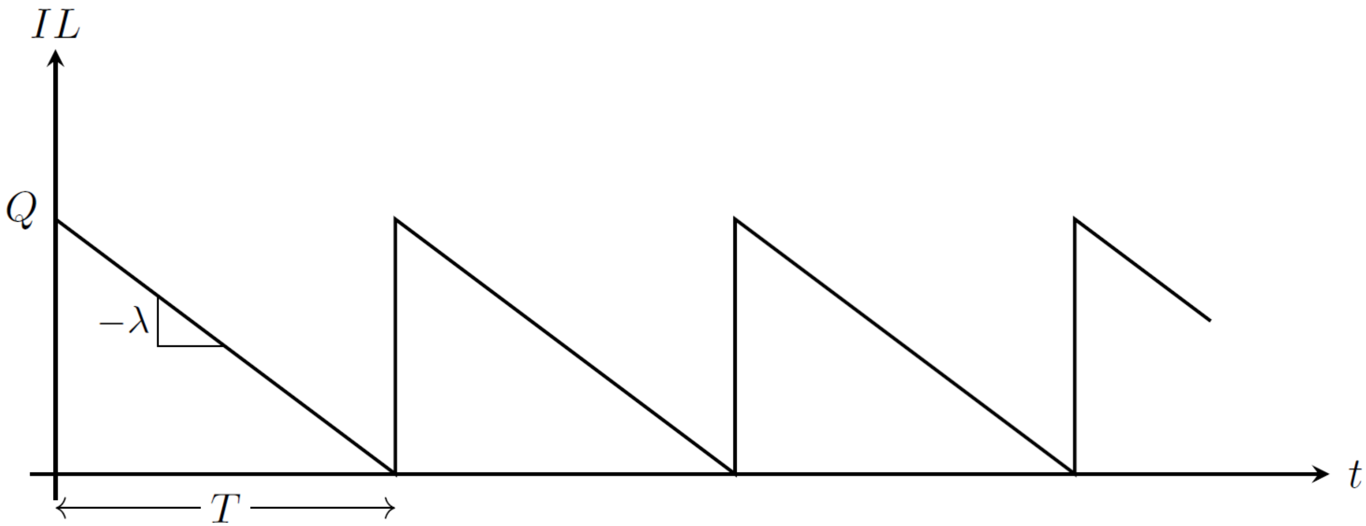
OUTPUT: The optimal ordering strategy



$$T = \frac{Q}{\lambda}.$$

Figure 3.2 EOQ inventory level curve.

Economic Order Quantity (EOQ)



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$$g(Q) = \frac{K\lambda}{Q} + \frac{hQ}{2}$$

EOQ

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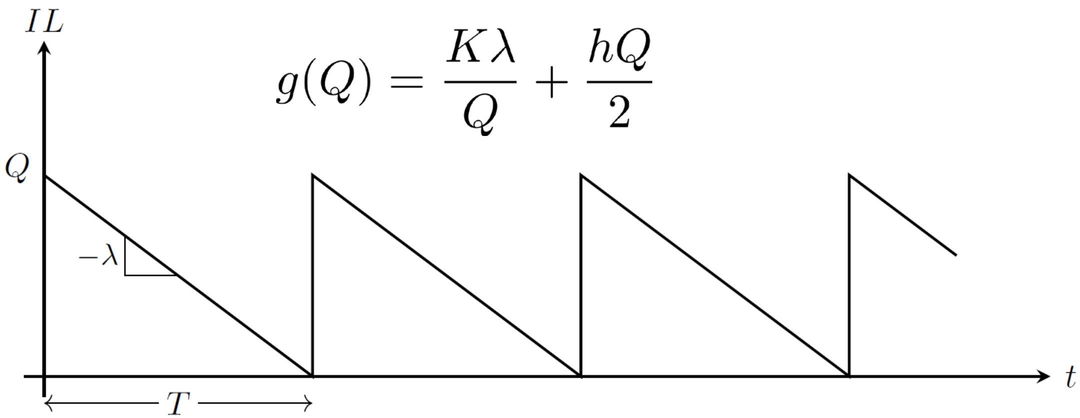


Figure 3.2 EOQ inventory level curve.

$$\frac{dg(Q)}{dQ} = -\frac{K\lambda}{Q^2} + \frac{h}{2} = 0$$

$$\implies Q^2 = \frac{2K\lambda}{h}$$

$$\implies Q^* = \sqrt{\frac{2K\lambda}{h}}$$

$$g\left(Q^*\right) == \sqrt{\frac{K\lambda h}{2}} + \sqrt{\frac{K\lambda h}{2}} = \sqrt{2K\lambda h}$$

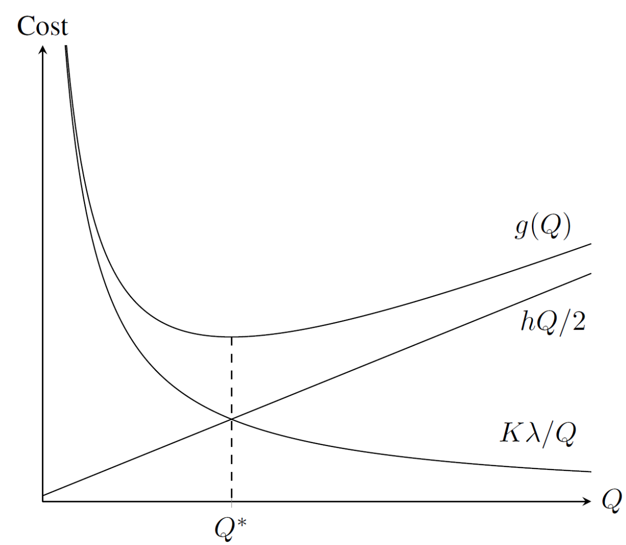


Figure 3.3 Fixed, holding, and total costs as a function of Q.

Adding a Lead Time L?

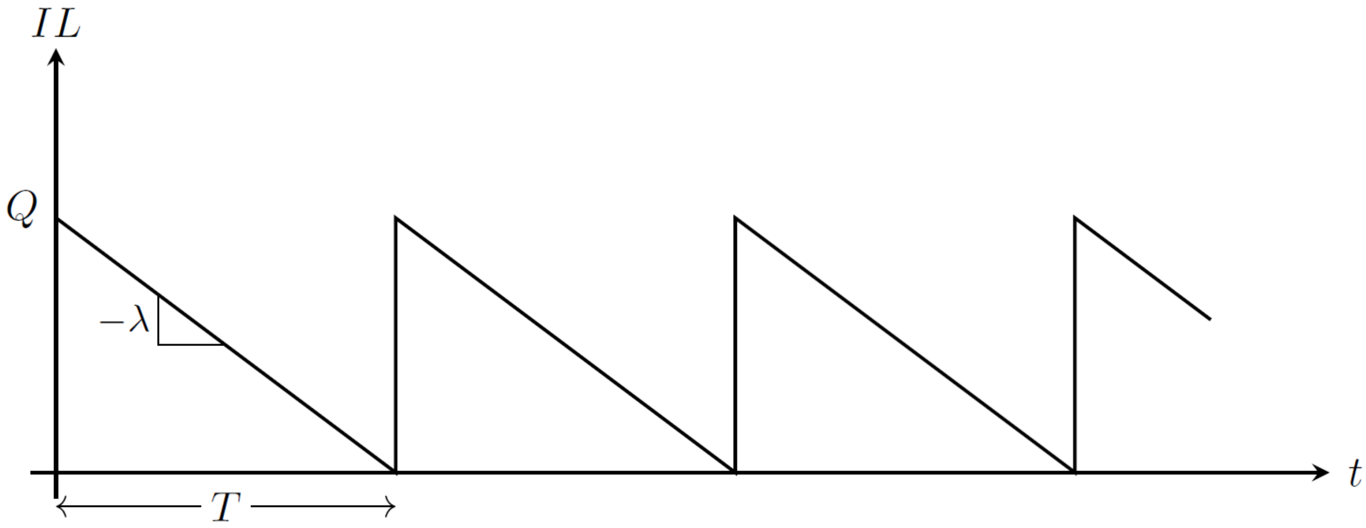


Figure 3.2 EOQ inventory level curve.

Power of Two Polices

- Sensitivity of order quantity

$$\frac{g(Q)}{g(Q^*)} = \frac{1}{2}\left(\frac{Q^*}{Q} + \frac{Q}{Q^*}\right)$$

- What if $T = T_B 2^k$ where *k* is some integer?

$$\frac{f(\hat{T})}{f(T^*)} \leq \frac{3}{2\sqrt{2}} \approx 1.06$$

EOQ with Backorders

- Let x be the fraction of demand that is backordered

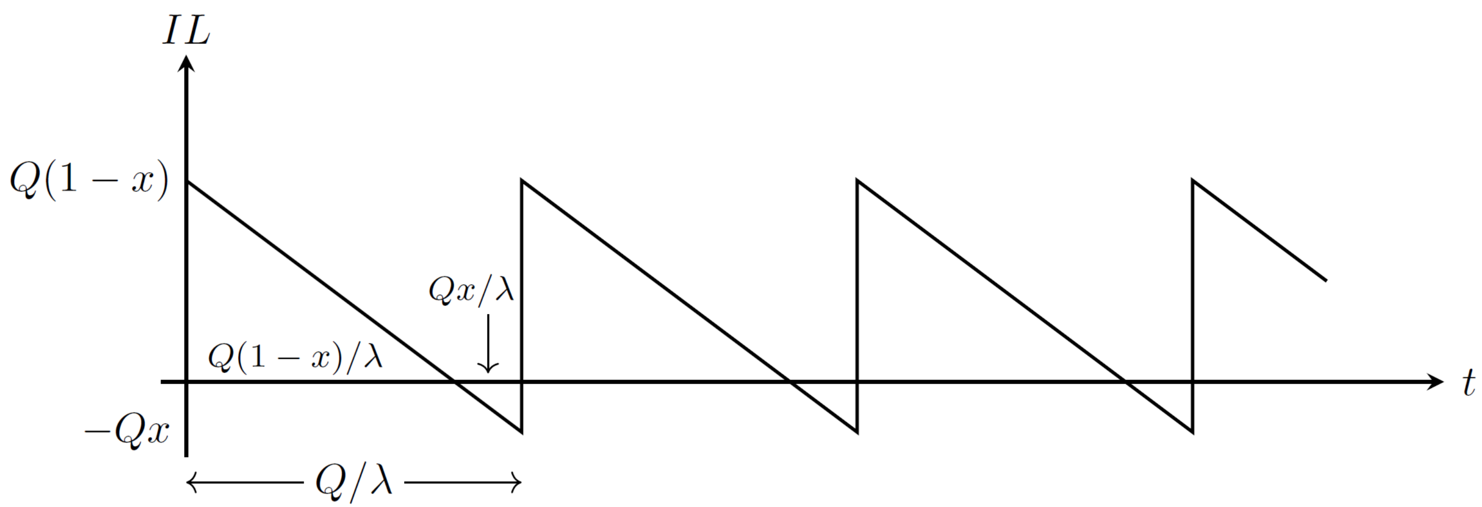


Figure 3.9 EOQB inventory curve.

$$g(Q,x) = \frac{hQ(1-x)^2}{2} + \frac{pQx^2}{2} + \frac{K\lambda}{Q}$$

EOQ with Backorders

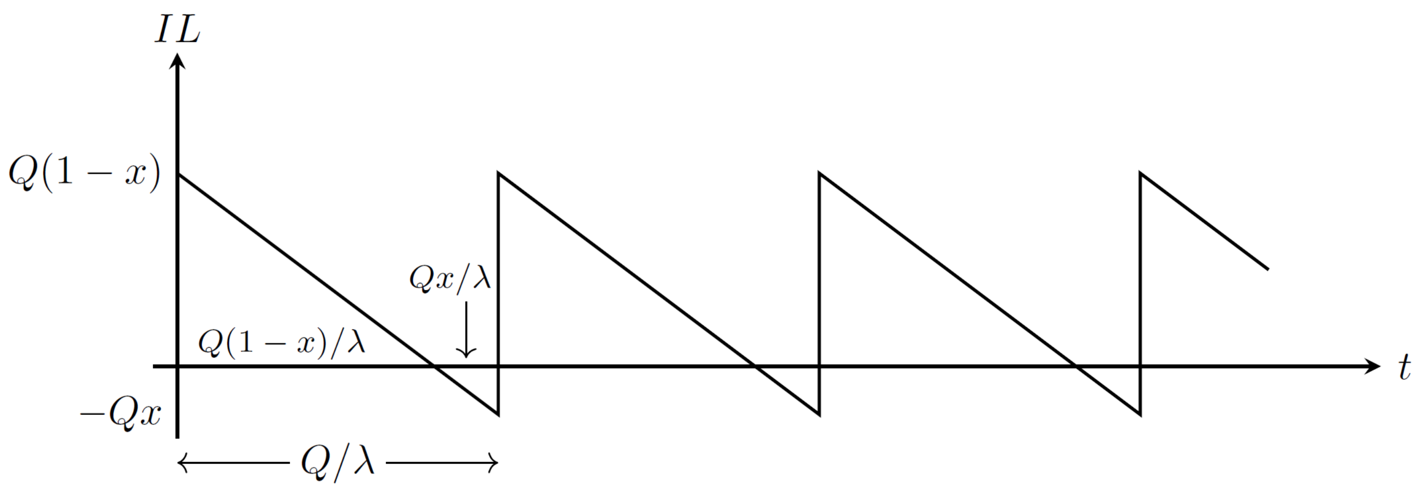


Figure 3.9 EOQB inventory curve.

$$g(Q,x) = \frac{hQ(1-x)^2}{2} + \frac{pQx^2}{2} + \frac{K\lambda}{Q}$$

$$\frac{\partial g}{\partial x} = -hQ(1-x) + pQx = 0$$
$$\frac{\partial g}{\partial Q} = \frac{h(1-x)^2}{2} + \frac{px^2}{2} - \frac{K\lambda}{Q^2} = 0$$

$$Q^* = \sqrt{\frac{2K\lambda(h+p)}{hp}}$$

$$x^* = \frac{h}{h+p}$$

$$g(Q^*, x^*) = \sqrt{\frac{2K\lambda hp}{h+p}}$$

EOQ with Backorders

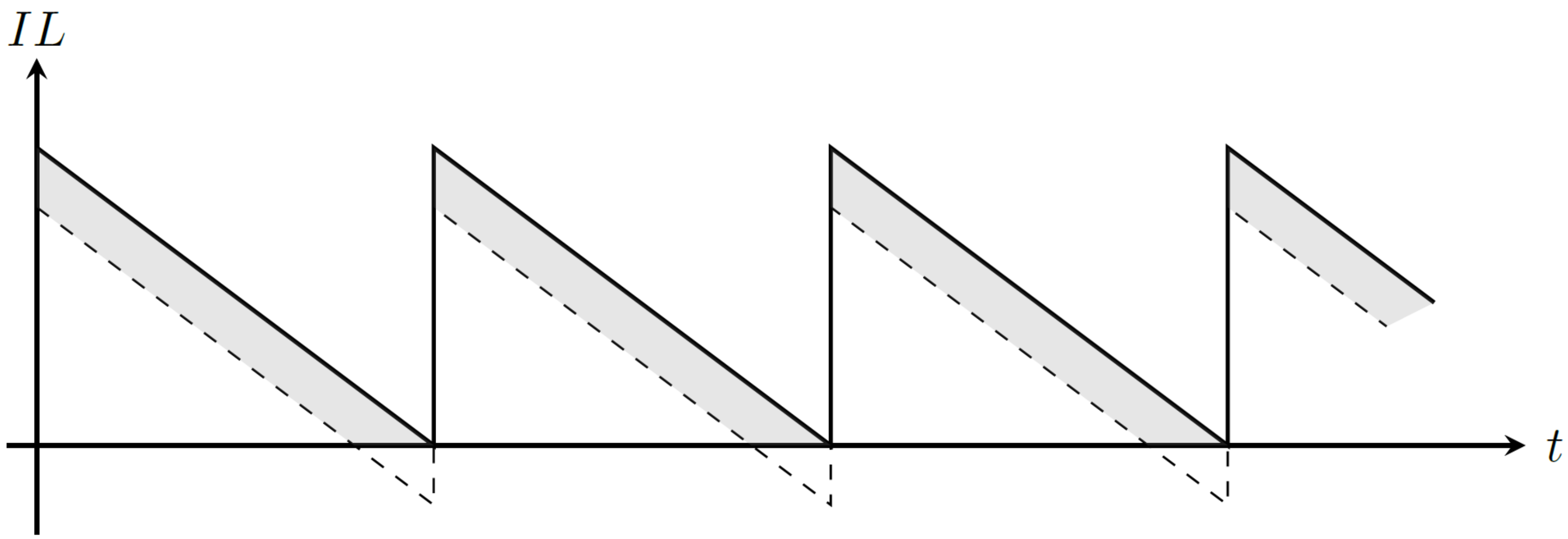
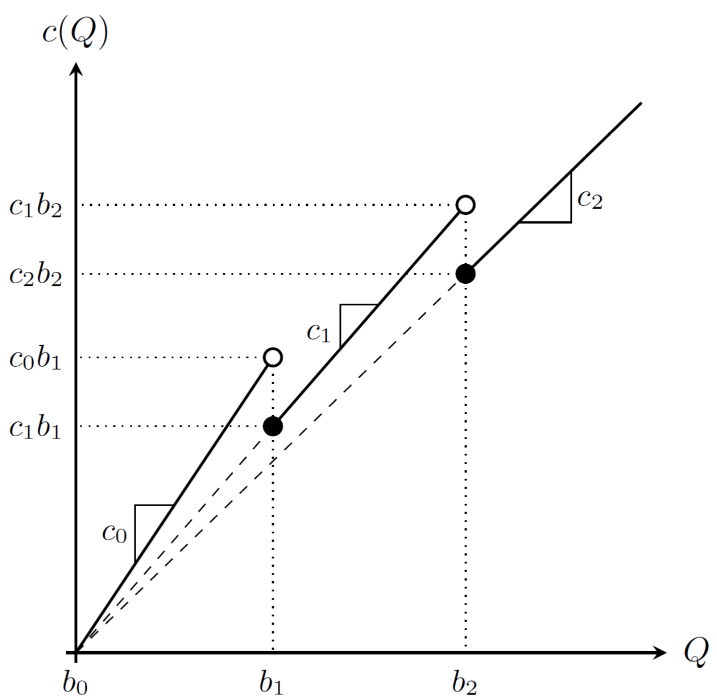


Figure 3.10 Inventory–backorder trade-off in EOQB.

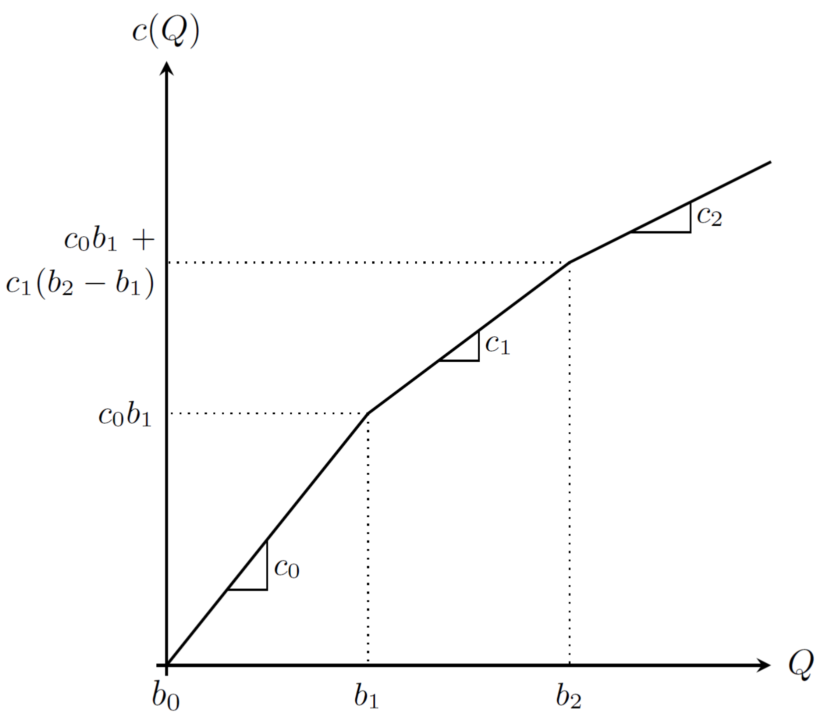
EOQ with Quantity Discount

All-Unit Discount



(a) All-units discounts.

Incremental Discount



(b) Incremental discounts.

All-Unit Discount

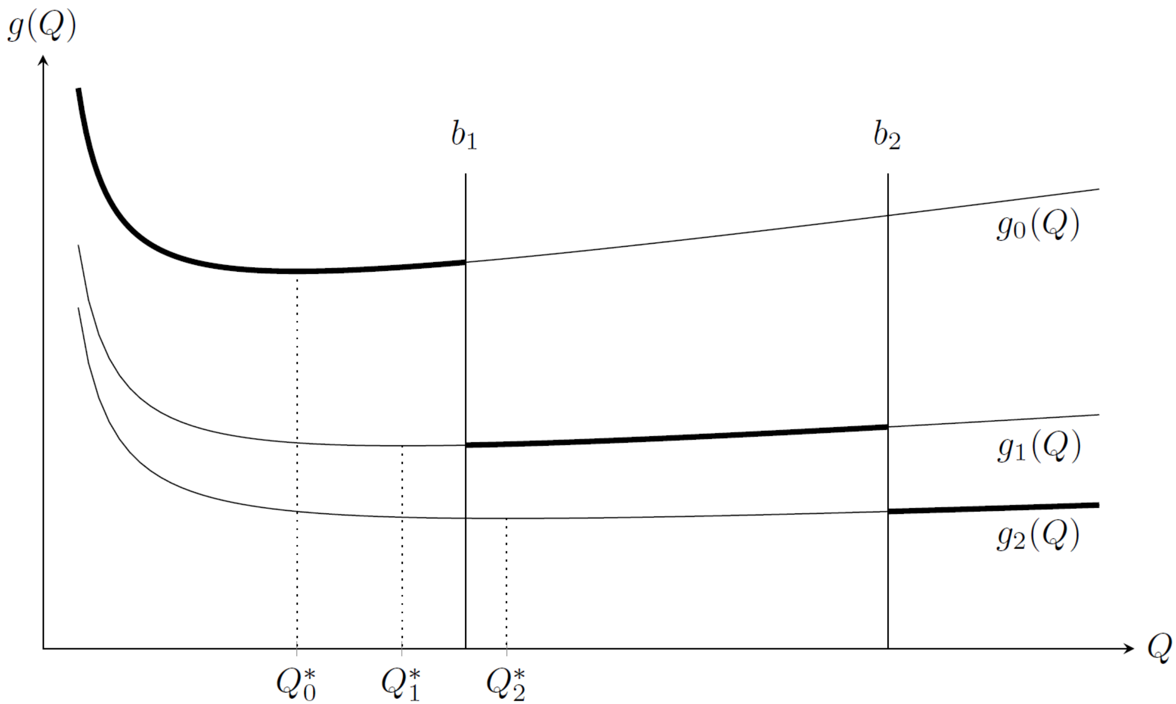


Figure 3.6 Total cost curves for all-units quantity discount structure.

$$g_j(Q) = c_j\lambda + \frac{K\lambda}{Q} + \frac{ic_jQ}{2}$$

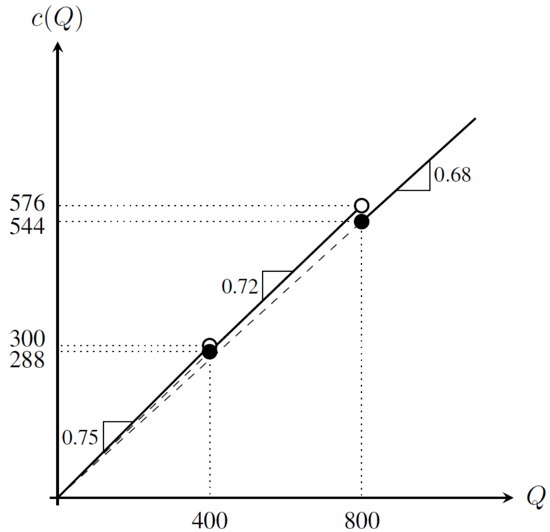
$$Q_j^* = \sqrt{\frac{2K\lambda}{ic_j}}$$

Algorithm:

1. Calculate Q_j^* for each j
2. Check feasibility (or realizability)
3. Calculate the cost of break points to the right of the largest realizable Q_j^*

All-Unit Example

$\lambda = 1300, K = 8, i = 0.3$



(a) All-units discounts.

$$Q_j^* = \sqrt{\frac{2K\lambda}{ic_j}}$$

We first determine the largest realizable Q_j^* by working backward from segment 2:

$$Q_2^* = \sqrt{\frac{2 \cdot 8 \cdot 1300}{0.3 \cdot 0.68}} = 319.3$$

$$Q_1^* = \sqrt{\frac{2 \cdot 8 \cdot 1300}{0.3 \cdot 0.72}} = 310.3$$

$$Q_0^* = \sqrt{\frac{2 \cdot 8 \cdot 1300}{0.3 \cdot 0.75}} = 304.1$$

Only Q_0^* is realizable, and it has cost

$$0.75 \cdot 1300 + \sqrt{2 \cdot 8 \cdot 1300 \cdot 0.3 \cdot 0.75} = 1043.4.$$

Next, we calculate the cost of the breakpoints to the right of Q_0^*:

$$g_1(400) = 0.72 \cdot 1300 + \frac{8 \cdot 1300}{400} + \frac{0.3 \cdot 0.72 \cdot 400}{2} = 1005.2$$

$$g_2(800) = 0.68 \cdot 1300 + \frac{8 \cdot 1300}{800} + \frac{0.3 \cdot 0.68 \cdot 800}{2} = 978.6$$

Therefore, the optimal order quantity is $Q = 800$, which incurs a purchase cost of \$0.68 and a total annual cost of \$978.60. $\square$

Incremental Discount

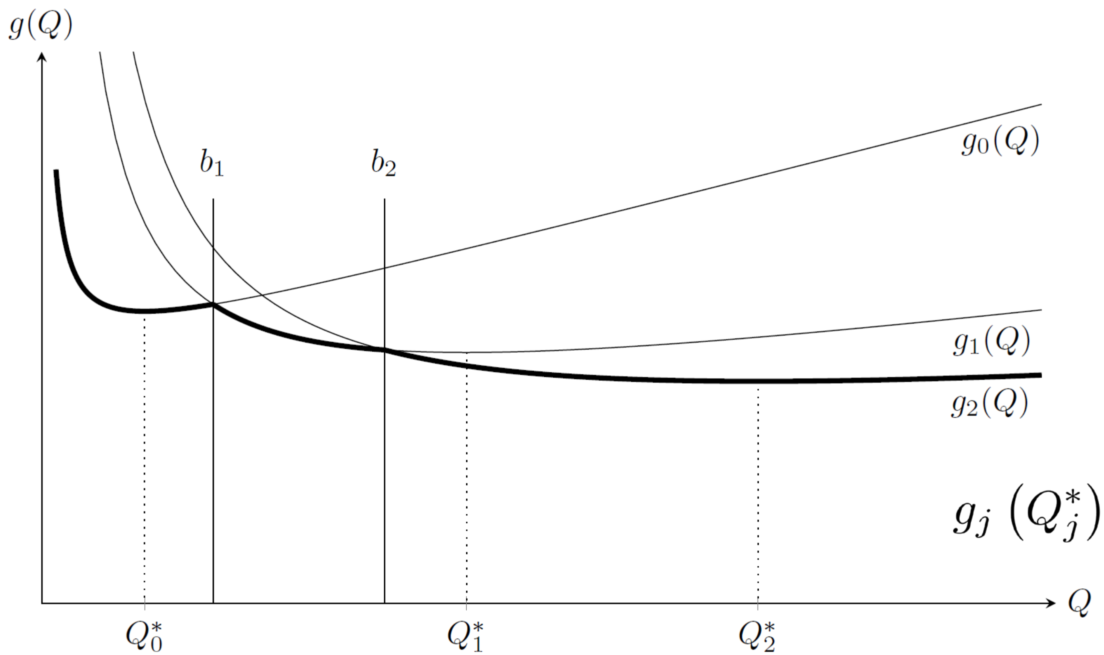


Figure 3.7 Total cost curves for incremental quantity discount structure.

$$g_j(Q) = c_j\lambda + \frac{i\bar{c}_j}{2} + \frac{(K+\bar{c}_j)\lambda}{Q} + \frac{ic_jQ}{2}$$

$$\bar{c}_j = \sum_{i=0}^{j-1} c_i\left(b_{i+1}-b_i\right) - c_jb_j$$

$$Q_j^* = \sqrt{\frac{2(K+\bar{c}_j)\lambda}{ic_j}}$$

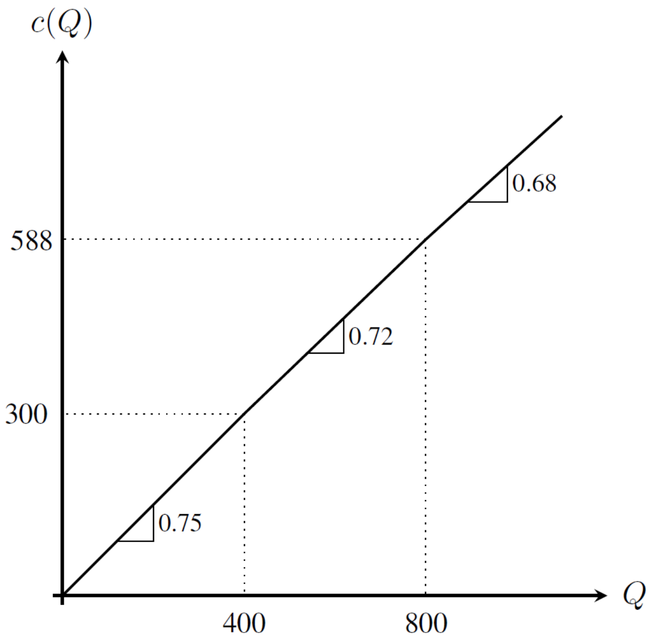
$$g_j\left(Q_j^*\right) = c_j\lambda + \frac{i\bar{c}_j}{2} + \sqrt{2(K+\bar{c}_j)\lambda ic_j}$$

Algorithm:

1. Calculate Q_j^* for each j
2. Check feasibility (or realizability)

Incremental Example

$\lambda = 1300, K = 8, i = 0.3$



(b) Incremental discounts.

$$Q_j^* = \sqrt{\frac{2\left(K+\bar{c}_j\right)\lambda}{ic_j}}$$

$$\bar{c}_1 = 0.75 \cdot 400 - 0.72 \cdot 400 = 12$$
$$\bar{c}_2 = 0.75 \cdot 400 + 0.72 \cdot 400 - 0.68 \cdot 800 = 44$$

Next, we calculate Q_j^* for each j:

$$Q_0^* = \sqrt{\frac{2(8+0)1300}{0.3 \cdot 0.75}} = 304.1$$
$$Q_1^* = \sqrt{\frac{2(8+12)1300}{0.3 \cdot 0.72}} = 490.7$$
$$Q_2^* = \sqrt{\frac{2(8+44)1300}{0.3 \cdot 0.68}} = 814.1$$

All three solutions are realizable. Using (3.22), these solutions have the following costs:

$$g_0(Q_0^*) = 0.75 \cdot 1300 + \frac{0.3 \cdot 0}{2} + \sqrt{2(8+0)1300 \cdot 0.3 \cdot 0.75} = 1043.4$$
$$g_1(Q_1^*) = 0.72 \cdot 1300 + \frac{0.3 \cdot 12}{2} + \sqrt{2(8+12)1300 \cdot 0.3 \cdot 0.72} = 1043.8$$
$$g_2(Q_2^*) = 0.68 \cdot 1300 + \frac{0.3 \cdot 44}{2} + \sqrt{2(8+44)1300 \cdot 0.3 \cdot 0.68} = 1056.7$$

Therefore, the optimal order quantity is $Q = 304.1$, which incurs a total annual cost of \$1043.40. $\square$

Economic Production Quantity (EPQ)

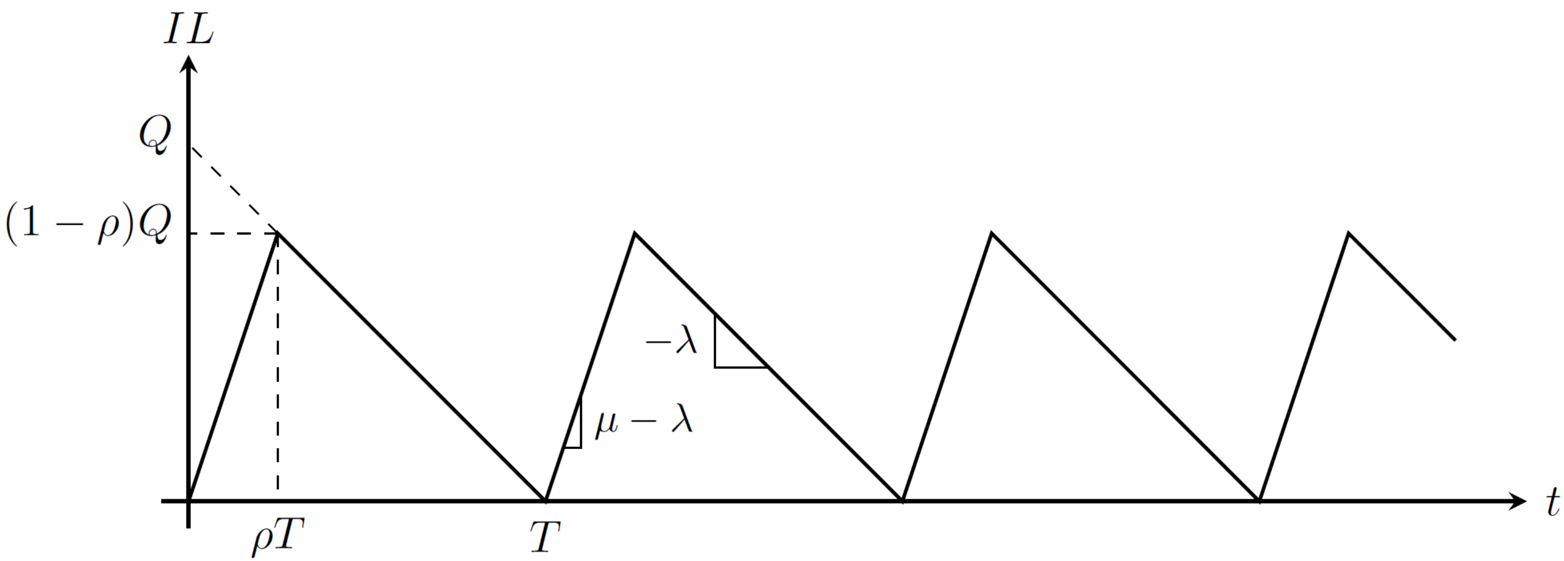


Figure 3.11 EPQ inventory level curve.

$$g(Q) = \frac{K\lambda}{Q} + \frac{h(1-\rho)Q}{2}$$

$$Q^* = \sqrt{\frac{2K\lambda}{h(1-\rho)}}$$

$$g(Q^*) = \sqrt{2K\lambda h(1-\rho)}$$

Summary

- Basic Deterministic Inventory Models
  - EOQ
  - EOQ with backorders
  - EOQ with quantity discounts (all-unit and incremental)
  - EPQ

- Next Up: Wagner-Whitin Model