

CONSIGNMENT SALES

Whitepaper

Suppliers and Manufacturers Advantage?

Consignment Sales

WHOLESALE \ MANUFACTURER CONSIGNMENT SALES IS IT RIGHT FOR YOUR BUSINESS?

Consignment, like layaway, is an old retail service that is seeing new life in these down economic times, a re-emerging option offered by wholesalers and manufacturers. Usually, retailers will expect a higher margin to suppliers who want the money for their goods up front. A lower margin is accepted from those vendors who are willing to wait until the products are actually sold. In either case, the retailer typically takes a greater portion of the profits, albeit not nearly as much as selling paid for items. The supplier has the advantage of placing goods on to store shelves, closer to the end user, thereby converting inventory to cash much sooner.

A consignment occurs when suppliers (the “consignor”) provide goods to a reseller (the “consignee”), whereby they agree to pay the proceeds from the sales minus a commission.. The consignee reserves the right to return any product that does not sell, and thus the consignee assumes very little risk for they do not have to purchase the goods. The advantage to the supplier is that it provides access to sales outlets that might not otherwise be available.

Consignment sales can be big business. For example, in craft sales alone, consignments account for more than \$3 billion annually in the United States. These numbers can be exhilarating, however, prior to jumping into consignment sales, you should consider the following:

- The credit worthiness of your consignee
- Having a written consignment agreement that spells out the inventory being consigned
- An agreed upon retail price the goods will be sold for where applicable
- The consignee’s fees
- Who pays for shipping (FOB point)
- The type and amount of insurance that the consignee will carry to protect merchandise
- When the agreement will begin and terminate
- How returns will be handled
- Frequency of sell though information exchange
- Terms of sales on invoices for goods sold
- Advertising allowances
- Shelf positioning
- Retailer commitment
- Cycle count adjustments
- Scrap or damage claims
- Real-time or period-end sales

Different Approaches to Consignment Inventory

There is no “right” approach to the consignment process for the supplier, for there are a variety of approaches that are all used in the marketplace.

- Pay as sold (daily)
- Pay as sold during a defined period
- Ownership changes after a defined period
- Order to order consignment –when next consignment order is shipped previous is billed in total
- Simply as a back-end accounting process on the Supplier side

"You have to have the technology infrastructure in place to pull this off. You have to have inventory visibility."

Mike Dominy, Yankee Group

Ideally, the consignment status of the inventory should be invisible to most workers (warehouse, manufacturing, sales order processing). Problems can arise if these workers process consignment inventory transactions differently from non-consignment transactions. These problems can range from minor annoyances and delays in processing transactions, to very serious data integrity issues.

In all cases, visibility of inventory from the consignee to the supplier is essential. Few if any retailers can provide sufficiently accurate inventory levels at the individual store level that can be communicated back to the supplier. Most consignment tracking is therefore relegated to total piece count across the retail chain from a virtual warehouse point of view. Consignment invoicing becomes the mechanism to decrement the on-hand in order to capture cost of goods and unsold inventory balances.

At all times, consideration must be given to the costing methodology across the suppliers' enterprise. If an item requires either a standard cost or moving average cost correction, will the consigned unsold goods be considered in the calculation?

Legal Considerations

Contractually speaking, you and your consignee can agree to a variety of mutually advantageous measures. For example, you negotiate that merchandise will be placed in the wholesale or retail business where it is exposed to a minimum 50 percent of foot traffic that enters the store.

In addition, you should agree as to the exact commission to be awarded to the consignee upon sale of the merchandise and the frequency (days, weeks, etc.) which the consignee will make payments for goods sold.

An agreement concerning delivery and pick-up of the merchandise should be considered, as well as conditions of storage of any merchandise that is not on display, particularly perishable, fragile, or expensive items. Your contractual agreement might specify that you will be paid for "inventory sold", when Inventory Delivered Less Inventory Collected Equals Inventory Sold.

However, this payment term assumes that all merchandise will be either sold or claimed by the consignor and fails to acknowledge the possibility of shrinkage, either on the sales floor or elsewhere in the supply-chain. Since shoplifting and damages caused by shoppers during handling, or improper storage (such as UV damage from item stored in direct sunlight) are sobering realities of doing business, it is wise to consider and negotiate what will happen before it occurs.

The merchandise legally belongs to the consignor in a consignment sale whereby the consignor is liable for any loss. Some consignees may be willing to share the responsibility involved in loss due to shoplifting if the issue is handled tactfully.

In some cases, the consignee will assume responsibility for damaged goods, thereby giving zero risk to the manufacturer. However, such cases are rare, and at best, you can expect a sharing of the loss with the consignee.

When you assume part or all of the loss, you should insist that all damaged goods be returned, for a consignee could claim that some of your merchandise was damaged when in fact the consignee sold it and pocketed the money.

Where Consignment Works Best

There are a variety of situations where suppliers may consider consignment selling as a viable, even preferred option to market goods. The question becomes where does it work well?, and where does it not work well?

It works well for:

- New or unproven products/brands
- The introduction of existing product lines into new sales channels
- Very expensive products where sales are questionable, and inventory acquisition cost are high

The key to all of the above, 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.

Take the example of the bicycle shop that sells products to a predominately 'weekend warrior' clientele. Historically, any bicycle that sells in the \$200 to \$500 range is in those retailers' "sweet spot." The supplier introduces a new line of "Lance Armstrong" bikes for the enthusiast cyclers selling for \$2,000. The supplier may offer the retailer a few on consignments just to gauge the market before deciding on the appropriate inventory mix.

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

Where consignment is not a good model

Where is consignment inventory less effective or even counterproductive? It is not recommended to use consignment inventory as a localized cost-cutting tactic or be considered a "temporary" reaction to a slow market. Major customers can pressure their suppliers into providing consignment inventory to eliminate their investment in inventory. In these situations, the customer was most likely already stocking the product and is simply using one's leverage over the supplier to reduce one's costs. While this may reduce the customer's costs, it is actually just relocating 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. Therefore, in the end, the supply chain has to absorb more costs without any meaningful benefits. Once the retailer is given the opportunity to procure inventory at no cost, that door is open and unlikely to close when conditions improve.

A potential side benefit to consignment sales is that the shared sales information that results from the consignment process, can provide useful intelligence to the supplier. For example, what region is selling best?, or which size turns more quickly? Unfortunately, this information is rarely integrated into their planning systems, and thus requires very different system logic to utilize customer inventory levels in the planning processes. However, if consignment inventory is only a small part of the overall business, it may not be cost-effective to add the complexity. In addition, POS sell-through information provided to the supplier, typically using the EDI 852 Inventory Movement transaction, is often inaccurate and unreliable. This forces the supplier to manage data on a customer by customer basis, thereby creating significant overhead to the process.

Advantages of Consignment Selling

Now that you have reviewed some general facts about consignment selling, below are the specific advantages to you as a manufacturer or wholesaler:

- It allows a seller to place merchandise in retail outlets that would otherwise not be available.
- It can provide an incentive for retailers to carry certain items because their capital is not tied up in inventory.
- It can encourage retailers to stock seasonal or otherwise newly introduced merchandise which they might not usually buy because of a questionable demand.
- It provides the manufacturer or wholesaler with the opportunity to have the merchandise exposed to retail customers, rather than stored and isolated in a warehouse while waiting for an order from a buyer.

Disadvantages of Consignment Selling

- While your merchandise is being exposed on the shelves of a retailer, you receive no money until it sells, and cannot be sold to a customer who is willing to pay.
- As the supplier, you must have sufficient cash flow to survive extended periods for payments of merchandise sold.
- Since the goods are out of your physical control, you cannot control the damage and shopper abuse to which the goods are exposed to.
- You have little say in store/shelf placement to ensure exposure of the merchandise. due to the fact that consignees do not have any 'skin in the game' (i.e. capital invested in the inventory), they may be inclined to feature their outright-owned inventory in the most advantageous spots in order to realize a fast return on investment. Merchandise they own represents a liability until sold, while consignment merchandise does not.
- Where personal selling is important, outright-owned merchandise might be promoted at the expense of consigned goods because, again, return on investment matters only where investment exists.
- If the gross margin to the seller is greater than the percentage commission with the sale of consigned goods, then the seller might tend to favor selling the outright-owned goods. For this reason, the consignee is compelled to provide attractive incentives in the form of commissions or SPIFFs to the consignee. In other words, the consignee needs extra motivation to sell the merchandise since the motive to recoup investment is not present.
- Since title does not pass to the consignee in the absence of an agreement, liability of loss for the merchandise remains with the consignor. Therefore, it is crucial that you and the consignee agree to specific conditions for assuming a share of the loss or damage to the merchandise. However, in the absence of such an agreement, you, the consignor, are responsible for the loss involved even though the merchandise might have been shoplifted from the premises of the seller while the consignee exercised normal care in the display and handling of the merchandise.

In the current retail climate, both vendors and retailers are looking for creative ways to grow their businesses. Under certain conditions consignment sales may be a win-win situation. Knowing the benefits and pitfalls beforehand will inform the negotiation of the consignment agreement, helping to solidify a mutually beneficial partnership.

About the Vision Suite

All of Jesta I.S.' solutions are real-time, web-based applications that automate complex business processes, manage workflow and deliver exception-based business intelligence to our clients. Each solution is internationalized and modular allowing our clients to use only the modules they need. Jesta I.S. is committed to continuous product development based on customer feedback as well as internal and external market analysis.

From retailers who source their own goods, to manufacturers who are selling direct to the consumer, Jesta's Vision Suite provides organizations with end-to-end solutions for ERP, Retail, Store Operations and Supply Chain Management. The Vision Suite includes; Vision Merchandising, Vision Financials, Vision Planning, Vision Store, Vision SCM, and Vision Sourcing & Demand Management.

About Jesta I.S. Inc.

Jesta I.S. is a leading supplier of business solutions in supply chain management systems for manufacturers, distributors and retailers primarily in the soft goods and specialty industries worldwide. Jesta I.S. is recognized for its expertise, innovative products and services and its commitment to evolving business solutions in today's rapidly changing business world. Jesta I.S.' solutions process essential business management information for well known industry leaders including Perry Ellis International (NASDAQ: PERY), PUMA AG (XETRA: PUMV.DE), Genesco Inc. (NYSE: GCO), Town Shoes Limited, Cole Haan, Hagggar Clothing Co., Cavender's Boot City, DSW Inc. (NYSE: DSW) as well as many others.

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