

more precise schedule adjustments and the optimal distribution of bus types by departure time.

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THE SECRET COSTS OF "STUFF": UNDERSTANDING INVENTORY COSTS

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Inventory is often seen as a simple asset on a company's balance sheet. More stock means more products ready to sell, which should mean more revenue, right? In reality, inventory is a double-edged sword. While necessary to meet customer demand and ensure smooth operations, holding stock comes with a complex web of hidden expenses that can quietly drain a company's profits. These are the secret costs of "stuff"—the expenses that go far beyond the simple purchase price of the goods.

This article aims to demystify inventory costs by breaking them down into their core components. We will explore the difference between direct and indirect costs, introduce the classic triad of holding, ordering, and shortage costs, and finally, discuss how businesses can use this understanding to unlock significant savings.

The Iceberg of Inventory Costs To visualize the problem, imagine an iceberg. The tip, visible above the water, represents the direct cost of the inventory—the price paid to the supplier for the goods. This is the figure that appears on the invoice and is most obvious to management.

However, the majority of inventory costs are hidden beneath the surface. These are the indirect costs: warehousing, insurance, taxes, obsolescence, damage, theft, and the capital tied up that could have been invested elsewhere. For many companies, these hidden costs can add 20% to 40% or more to the direct cost of the inventory annually.

Failing to manage these secret costs is like sailing an expensive ship through dangerous waters while ignoring the massive iceberg directly ahead.

The Three Pillars of Inventory Costs To understand and manage inventory effectively, financial and operations managers typically break costs down into three distinct categories. The goal of any efficient inventory system is to find the optimal balance between them.

Holding Costs (Carrying Costs) These are the costs associated with storing and maintaining inventory over a period of time. They are variable and increase the longer you hold onto a product. Holding costs typically include:

- Capital Cost: This is often the largest component. It represents the opportunity cost of the money tied up in inventory. Instead of buying stock, that capital could have been used for marketing, R&D, new equipment, or even earning interest in a bank account.

- Storage Space Cost: Rent, utilities, maintenance, and depreciation on the warehouse or storage facility. Even if a company owns its warehouse, there is an opportunity cost for using the space for slow-moving stock instead of something more productive.

- Inventory Service Cost: Expenses directly related to the stored goods, such as property taxes and insurance premiums.

- Inventory Risk Cost: These are the unpredictable but inevitable losses. Obsolescence (products becoming outdated, especially in technology or fashion), damage (goods broken in the warehouse), shrinkage (theft by employees or customers), and spoilage (for perishable goods like food or medicine).

Ordering Costs These are the costs incurred every time a purchase order is placed with a supplier. The goal is to minimize these costs by placing larger, less frequent orders. Ordering costs include:

- Administrative costs: Processing the purchase order, contacting the supplier, and managing the paperwork.

- Logistics and receiving costs: Scheduling inbound freight, unloading the delivery, inspecting the goods for quality and quantity, and moving them to the warehouse.

- Setup costs: If a company manufactures its own products, this includes the cost of preparing production lines for a specific item.

There is a direct trade-off here: If you order in large batches, you order less frequently, lowering your annual ordering costs. However, this increases your holding costs because you have more stock sitting in the warehouse for longer.

Shortage Costs (Stockout Costs) These are the most dangerous and often least understood costs. They represent the consequences of not having enough inventory to meet demand. Shortage costs are difficult to calculate because they often involve lost future business. They include:

- Lost Contribution Margin: The immediate lost profit from a sale that could not be completed because the item was out of stock.

- Loss of Customer Goodwill: A customer who leaves empty-handed may decide to buy from a competitor and not return. This damages the brand's reputation and long-term customer lifetime value.

- Expediting Costs: The extra expense of air-freighting goods or rushing a production run to fill an unexpected demand spike. These costs are often much higher than normal shipping.

- Production Delays: A shortage of a single component can shut down an entire assembly line, leading to idle workers and late delivery of finished goods to other customers.

The Economic Order Quantity (EOQ) Model The delicate balance between holding, ordering, and shortage costs is the foundation of modern inventory management. The classic Economic Order Quantity (EOQ) model is a formula used to determine the ideal order quantity a company should purchase to minimize the total cost of inventory. The formula attempts to find the single point where the line for holding

costs (which increase with order size) and ordering costs (which decrease with order size) intersect.

While the EOQ model has its limitations—it assumes constant demand, known costs, and immediate delivery—it provides a powerful conceptual framework. It forces managers to think beyond the purchase price and recognize that the cheapest order quantity is not always the most cost-effective one.

Understanding the Total Landed Cost Another key concept is the Total Landed Cost (TLC). This is the complete cost of a product from the factory floor to the customer's doorstep. It includes the purchase price of the goods (the 'stuff'), plus all the secret costs we've discussed: shipping, customs duties, currency conversion fees, insurance, port handling, and final delivery to the warehouse. Businesses that fail to calculate TLC can end up selling a product at a loss, believing they are making a profit based on the initial, lower purchase price.

Strategies to Unlock Hidden Value Understanding these secret costs is the first step. The second is taking action. Here are several strategies businesses use to turn this knowledge into savings:

1. **Reduce Inventory Levels.** The most direct way to cut holding costs is to hold less stock. This requires implementing Just-In-Time (JIT) or demand-driven inventory systems. This reduces capital tied up, storage needs, and risk of obsolescence.

2. **Improve Forecast Accuracy.** Most shortages (and resulting expediting costs) are caused by poor demand forecasting. Investing in better data analytics and collaborative planning with customers can significantly reduce stockouts and the need for 'panic buying'.

3. **Analyze Slow-Moving Stock.** Conduct a regular ABC analysis. Identify the 'C' items (low-value, slow-moving products) that consume a disproportionate amount of storage space and management time. Consider discounting, returning, or even discontinuing these lines to free up resources.

4. **Negotiate with Suppliers.** Use your knowledge of ordering costs to negotiate better terms. Can your supplier deliver more frequently in smaller batches without increasing the per-unit price? This would lower your holding costs.

5. Calculate the True Cost of "Cheap". Before sourcing from a distant supplier offering a lower purchase price, calculate the Total Landed Cost. A local supplier with a slightly higher per-unit price might be significantly cheaper when you account for shipping, tariffs, and the cost of holding inventory for weeks in transit.

Conclusion Inventory is not just an asset; it is an expense driver. The secret costs of "stuff"—holding, ordering, and shortage costs—can erode profitability and tie up capital that could be used for growth. However, by recognizing these hidden expenses, managers can move beyond simplistic thinking and implement sophisticated inventory optimization strategies.

The goal is not necessarily to have less inventory, but to have the right inventory. When a company masters this balance, inventory shifts from being a financial burden to a true strategic asset, fueling customer satisfaction and long-term, sustainable profit. Understanding these costs is not just an accounting exercise; it is a competitive necessity in today's complex global supply chain.

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THIRD-PARTY LOGISTICS: A STRATEGIC PARTNER FOR MODERN SUPPLY CHAINS

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