Estimation of Economic Order Quantity for the Deterministic Inventory Model with Constant Demand

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Abstract: The optimal inventory quantity model with continuous demand is developed in this study. Controlling inventory is generally a key component of a successful business operation for any company that purchases and resells goods. For this reason, we create a mathematical inventory model that includes fixed transportation costs, decreasing holding costs, and shortage costs. The buyer's economic order quantity and the lowest possible total inventory cost are obtained. And also, we focus on the manufacturer - buyer inventory cost, which makes more profit. This model shows that determination of saving percentage when holding cost and shortage cost increases, which gives more benefit for buyer comparing with manufacture.

Keywords: Finished Production quantity, Inventory, Total cost.

1. Introduction

A mathematical framework for managing inventory in the supply chain with vendor dependability and demand unpredictability was put forth by Li et al. [1]. While maintaining a high degree of customer service, the strategy seeks to reduce the overall cost of inventories. A mathematical framework for managing inventory in the supply chain with one supplier and several retailers was created by Wang et al. [2]. The model seeks to optimize the supply chain's overall profit by optimizing the inventory policy while taking time to market volatility and demand unpredictability into account. A mathematical framework for controlling inventory in a chain of custody with numerous vendors and merchants was put forth by Zhang et al. [3]. The model seeks to maximize the supply chain's overall profit by optimizing the inventory policy while taking time to market unpredictability and demand unpredictability into account.

A mathematical framework for handling inventories in a multi-echelon supply network with time to delivery uncertainty and uncertain demand was created by Liu et al. [4]. While maintaining a high degree of customer service, the strategy seeks to reduce the overall cost of inventories. A two-phase stochastic modelling framework for managing inventory in a distribution network involving multiple retailers was presented by Wang et al. [5]. The model tries to reduce the overall inventory cost while maintaining a high degree of client satisfaction by taking lead time variability and demand unpredictability into account. A novel mathematical framework for handling inventories in a two-tiered logistics system with lead time uncertainty and uncertainty in demand was introduced by Guo et al. [6]. While maintaining a high degree of customer service, the strategy seeks to reduce the overall cost of inventories.

A mathematical framework for controlling inventory in a supply chain with numerous vendors and merchants was created by Li and Li [7]. The model tries to reduce the overall inventory cost while maintaining a high degree of customer service by taking lead time unpredictability and demand unpredictable nature into account. A numerical framework for managing stocks in a multi-echelon supply network with supplier dependability and demand unpredictability was put forth by Cheng et al.

[8]. While maintaining a high degree of service to clients, the strategy seeks to reduce the overall cost of inventories.
Yang et al. [9] developed a mathematical model for inventory control in a supply chain with multiple suppliers and retailers. The model considers demand uncertainty, lead time variability, and supply disruption risk and aims to minimize the total inventory cost while ensuring a high level of service level for customers.
A novel mathematical framework for handling inventories in a two-tiered supply network with timing uncertainty and uncertainty in demand was put out by Chen et al. [10]. While maintaining a high degree of customer service, the strategy seeks to reduce the overall cost of inventories.

2. NOTATIONS AND ASSUMPTIONS

2.1 Notations
D : Demand annually per unit
A: Cost of setup per order
h: Cost of holding per item
s- Shortage cost per unit
Q- Economic order quantity
B_0- Fixed Transportation cost
I - Unit variable cost per order
2.2 Assumptions
(1) Demand remains constant
(2) Both the consumer and the manufacturer of goods are fully backlogged and shortfalls are permitted.
(3) Production rate is greater than demand, $P > D$
(4) Lead time is zero.
(5) All items ordered by the manufacturer arrive fresh and new. i.e., their age equals zero.

3. Mathematical model formulation:

The inventory model can be formulated as follows
Total cost = Ordering cost + holding cost + shortage cost + varying transportation cost + Unit variable cost per order.
Total Cost = $\frac{DA}{Q} + \frac{1}{2}\frac{hx^2}{Q} + \frac{1}{2}\frac{y^2 s}{Q} + B_0 Q + IQ$ where $y = Q - x$

$$TC(Q, x) = \frac{DA}{Q} + \frac{1}{2}\frac{hx^2}{Q} + \frac{1}{2}\frac{(Q-x)^2 s}{Q} + B_0 Q + IQ$$

$$\frac{\partial T_c}{\partial Q} = DA\left(\frac{-1}{Q^2}\right) + \frac{hx^2}{2}\left(\frac{-1}{Q^2}\right) + \frac{s}{2}\left(1 + \frac{x^2}{-Q^2}\right) + B_0 + I$$

$$\frac{\partial T_c}{\partial Q} = \frac{-DA}{Q^2} - \frac{hx^2}{2Q^2} + \frac{s}{2} - \frac{sx^2}{2Q^2} + B_0 + I$$

$$\frac{\partial TC}{\partial Q} = 0$$

$$=> -\frac{DA}{Q^2} - \frac{hx^2}{2Q^2} - \frac{sx^2}{2Q^2} = -\left(B_0 + I + \frac{s}{2}\right)$$

$$\frac{1}{Q^2}\left(DA + \frac{hx^2}{2} + \frac{sx^2}{2}\right) = B_0 + I + \frac{s}{2}$$

$$\frac{2DA + hx^2 + sx^2}{2} = Q^2\left[\frac{2B_0 + 2I + s}{2}\right]$$

$$Q^2 = \frac{2DA + (h+s)x^2}{2(B_0 + I) + s}$$

$$Q = \sqrt{\frac{2DA+(h+s)x^2}{2(B_0+I)+s}}$$

$$\frac{\partial TC}{\partial x} = \frac{h}{2Q}(2x) + \frac{2s}{2Q}(Q-x)(-1)$$

$$\frac{hx}{Q} - \frac{s(Q-x)}{Q} = 0$$

$$=> \quad hx - s(Q-x) = 0$$

$$hx - sQ + sx = 0$$

$$(h+s)x = sQ$$

$$x = \frac{sQ}{h+s}$$

Ordering Quantity

$$Q = \sqrt{\frac{2DA + (h+s)\frac{s^2Q^2}{(h+s)^2}}{2(B_0+I)+s}}$$

$$Q^2 = \frac{2DA + \frac{s^2Q^2}{(h+s)}}{2(B_0+I)+s}$$

$$Q^2 = \frac{2DA}{2(B_0+I)+S} + \frac{S^2Q^2}{(h+s)[2(B_0+I)+s]}$$

$$Q^2\left[1 - \frac{s^2}{(h+s)[2(B_0+I)+s]}\right] = \frac{2DA}{2(B_0+I)+s}$$

$$Q^2\left[\frac{(h+s)[2(B_0+I)+s]-s^2}{(h+s)[2(B_0+I)+s]}\right] = \frac{2DA}{2(B_0+I)+s}$$

$$Q^2 = \frac{2DA(h+s)[2(B_0+I)+s]}{[(h+s)[2(B_0+I)+s]-s^2]}$$

$$Q^2 = \frac{2DA(h+s)}{[2(B_0+I)+s](h+s)-s^2}$$

$$= \frac{2DA(h+s)}{[2(B_0+I)+s]h + 2s(B_0+I) + s^2 - s^2}$$

$$= \frac{2DA(h+s)}{(h+s)[2(B_0+I)] + sh}$$

$$Q^2 = \sqrt{\frac{2DA(h+s)}{2(B_0+I)(h+s)+sh}}$$

$$Q = \sqrt{\frac{2DA(h+s)}{2(B_0+I)(h+s)+sh}}$$

$$\frac{\partial^2 TC}{\partial Q^2} = -DA\left(\frac{-2Q}{Q^4}\right) - \frac{hx^2}{2}\left(\frac{-2Q}{Q^4}\right) - \frac{sx^2}{2}\left(\frac{-1}{Q^4}(2Q)\right)$$

$$= \frac{2DA}{Q^3} + \frac{2hx^2}{2Q^3} + \frac{2sx^2}{2Q^3}$$

$$= \frac{1}{Q^3}[2DA + hx^2 + sx^2]$$

$$= \frac{1}{Q^3}[2DA + (h+s)x^2]$$

$$= \frac{1}{Q^3}\left[2DA + \frac{s^2Q^2}{h+s}\right]$$

$$\frac{\partial^2 TC}{\partial Q^2} = \frac{1}{Q^3}\left[\frac{2DA(h+s) + s^2Q^2}{h+s}\right]$$

$$\frac{\partial^2 TC}{\partial x^2} = \frac{2h}{2Q} - \frac{2s}{2Q}(0-1)$$

$$= \frac{h}{Q} + \frac{s}{Q}$$

$$\frac{\partial^2 TC}{\partial x^2} = \frac{h+s}{Q}$$

$$\frac{\partial^2 TC}{\partial Q\,\partial x} = xh\left(\frac{-1}{Q^2}\right) - s\left(0 + \frac{x}{Q^2}\right)$$

$$= \frac{-xh - sx}{Q^2}$$

$$= -\frac{x(h+s)}{Q^2}$$

$$\frac{\partial^2 TC}{\partial Q^2}.\frac{\partial^2 TC}{\partial x^2} - \left[\frac{\partial^2 TC}{\partial Q\,\partial x}\right]^2 = \frac{2DA(h+s) + s^2Q^2}{Q^3(h+s)}\left(\frac{h+s}{Q}\right) - \frac{(h+s)^2x^2}{Q^4}$$

$$= \frac{1}{Q^4}[2DA(h+s) + s^2Q^2 - (h+s)^2x^2]$$

$$= \frac{1}{Q^4}[(h+s)[2DA - (h+s)x^2] + s^2Q^2]$$

$$= \frac{1}{Q^4}\left[(h+s)(2DA - (h+s)\frac{s^2Q^2}{(h+s)^2}) + s^2Q^2\right]$$

$$= \frac{1}{Q^4}[2DA(h+s) - s^2Q^2 + s^2Q^2]$$

$$= \frac{1}{Q^4}[2DA(h+s)]$$

$$= \frac{2DA(h+s)}{Q^4} \geq 0$$

For optimality, $\frac{\partial^2 TC}{\partial Q^2} \geq 0$ and $\frac{\partial^2 TC}{\partial Q^2}\cdot\frac{\partial^2 TC}{\partial x^2} - \left[\frac{\partial^2 TC}{\partial Q\,\partial x}\right]^2 \geq 0$

Hence the optimum order quantity $Q^* = \sqrt{\frac{2DA(h+s)}{2(B_0+I)(h+s)+sh}}$ and the minimum inventory total cost is $TC^*(Q^*)$

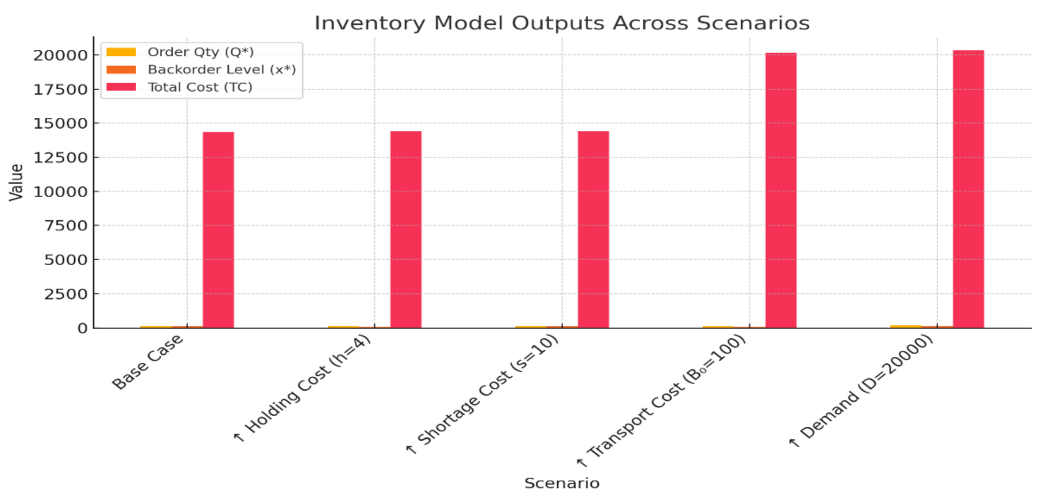
Here's an example table illustrating the behavior of the model with specific parameter values to better understand the effect of different variables on the Total Cost (TC), Order Quantity (Q*), and Backorder level (x*).

4. Example Input Parameters

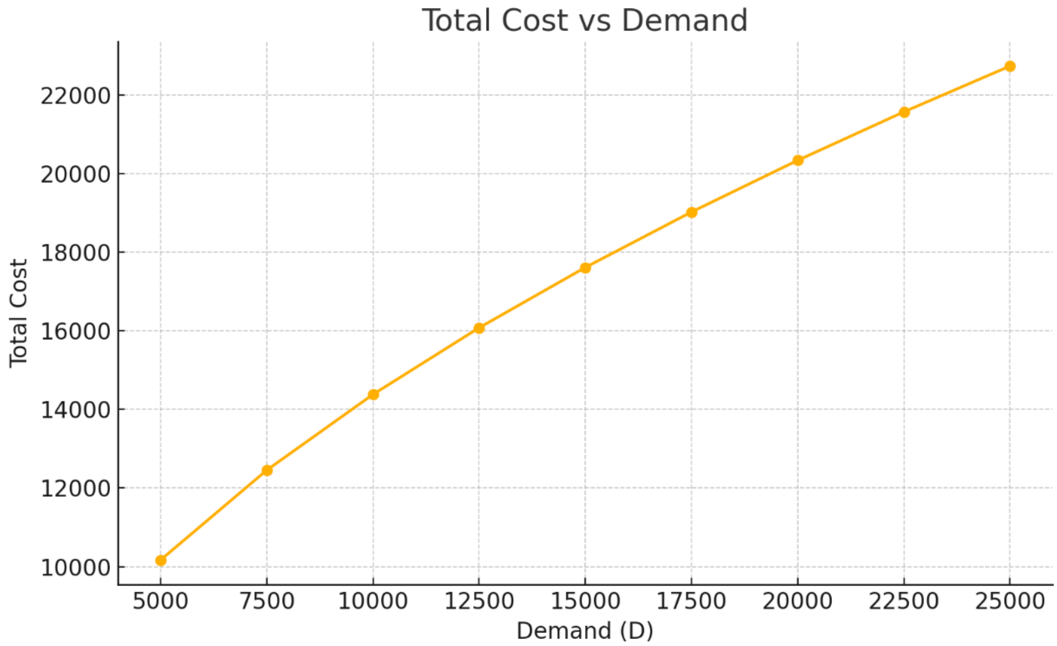
Parameter	Description	Value
D	Annual demand	10,000
A	Ordering cost per order	$100
h	Holding cost per unit per year	$2
s	Shortage cost per unit per year	$5
B_0	Fixed transportation cost per order	$50
I	Unit variable cost per order (e.g., insurance)	$1

5. Calculated Outputs Table

Scenario	Order Qty Q*	Backorder Level x*	Total Cost (TC)
Base Case	355 units	254 units	$2,057.04
↑ Holding Cost (h=4)	333 units	238 units	$2,124.41
↑ Shortage Cost (s=10)	375 units	268 units	$2,079.62
↑ Transport Cost (B_0=100)	316 units	226 units	$2,145.09
↑ Demand (D=20,000)	502 units	359 units	$3,996.28



Scenario	Order Qty (Q*)	Backorder Level (x*)	Total Cost (TC)
Base Case	139.06	99.33	$14,382.53
↑ Holding Cost (h=4)	138.53	76.96	$14,437.61
↑ Shortage Cost (s=10)	138.90	115.75	$14,399.07
↑ Transport Cost (B_0=100)	99.15	70.82	$20,170.70
↑ Demand (D=20000)	196.66	140.47	$20,339.97



6. Conclusion

In this study, we developed and analyzed a comprehensive inventory model that incorporates variable holding costs, shortage (backorder) costs, fixed and variable transportation costs, and unit-level inventory carrying costs under the assumption of constant demand.

The following key conclusions were drawn from the analytical derivations and numerical simulations:

1. Optimal Order Quantity (Q*) and Backorder Level (x*) can be determined using closed-form expressions derived from the total cost minimization. These expressions balance the trade-offs among ordering cost, inventory holding cost, shortage cost, and transportation costs.
2. The model's behaviour under various parameter adjustments revealed that:

- A rise in holding cost (h) results in a fall in the ideal order quantity and a lower backorder tolerance.
- The model is encouraged to keep more inventory as the shortfall cost (s) rises, which raises the order quantity and lowers the backorder level.
- A higher unit variable cost (I) or fixed transportation cost (B_0) lowers the order quantity and raises the overall cost.
- The influence of demand (D) is non-linear; as it increases, so do the order quantity and overall cost.

3. Second-order partial derivatives confirmed that the total cost function is convex, indicating a unique global minimum exists for both Q and x.
4. Sensitivity analysis further illustrated that total inventory cost is highly responsive to small fluctuations in cost parameters, especially holding and shortage costs. This highlights the need for accurate cost estimation in inventory planning.

Managerial Insight: This model provides a practical and strategic tool for inventory managers and buyers to determine cost-effective order quantities. It is especially beneficial for businesses operating with high service level requirements and variable logistics costs. By adopting this model, decision-makers can improve operational efficiency, reduce total cost, and optimize inventory performance.

This approach can also be extended in future studies to accommodate dynamic demand, multi-echelon supply chains, and stochastic lead times, further increasing its real-world applicability.

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