Dynamic Inventory Management Model for Deteriorating Items: A Stochastic Approach

Dr. Atma Nand*, Mr. Exbrowdy W Sangma[1], Mr. Shagun Bhardwaj[2]

School of Applied and Life Sciences, Uttaranchal University, Dehradun-248007*

Department of Mathematics, School of Applied and Life Sciences[1,2]

atmanand.prasad@gmail.com*

Abstract

Effective inventory management is crucial across various sectors such as food, warehousing, and agriculture. This paper presents a dynamic stochastic inventory control model for deteriorating items, incorporating both linear and nonlinear time dependencies in demand and deterioration rates. The model recognizes the inherent uncertainties in demand patterns and deterioration processes, reflecting real-world complexities. Central to this study is the collaborative relationship between merchants and consumers, essential for modern business dynamics. The objective is to determine the optimal ordering policies for consumers over the replenishment cycle to maximize expected total profit for both parties. Analytical modeling is employed to derive optimal solutions, and a comparative analysis of expected profits under collaborative and non-collaborative scenarios is conducted. A numerical example is provided, along with a sensitivity analysis to assess the impact of varying parameters on the optimal policy outcomes.

Keywords: Stochastic Inventory Management, Deteriorating Items, Demand Uncertainty, Profit Optimization, Sensitivity Analysis

1 Introduction

Efficient inventory control for deteriorating items is a significant challenge due to factors such as uncertain demand and the perishable nature of products. Traditional deterministic models often fall short in capturing the complexities of real-world scenarios where demand and deterioration are inherently random. This paper extends previous deterministic models by introducing stochastic elements into the demand and deterioration rates, providing a more realistic framework for inventory management.

1.1 Literature Review

Previous studies have addressed inventory management for deteriorating items under deterministic conditions (e.g., Silver and Meal [1], Ritchie [2, 3]). However, stochastic models offer a more accurate representation by accounting for randomness in demand and deterioration. Nahmias [4] provided an early review of perishable inventory models. More recent works include Goyal and Giri [5], who considered stochastic demand in perishable inventory models, and Bakker et al. [6], who discussed inventory models with stochastic deterioration. Recent advancements in inventory control theory have been applied in pharmaceutical sciences [7], and models addressing linear and non-linear time dependencies have been developed [8].

1.2 Contribution

This paper develops a stochastic inventory model that incorporates time-dependent, stochastic demand and deterioration rates. We derive analytical solutions using stochastic differential equations and apply these to a merchant-consumer framework, illustrating how collaboration can enhance expected profits.

2 Notations and Assumptions

2.1 Notations

- **Random Demand Process:**

$$
\begin{aligned}
D(t) &= b_i e^{\alpha_i t} + \sigma_i D_w(t) \\
b_i > 0 &\quad \text{Base demand rate for the } i^{\text{th}} \text{ consumer} \\
0 < \alpha_i < 1 &\quad \text{Growth rate of demand for the } i^{\text{th}} \text{ consumer} \\
\sigma_i &\quad \text{Standard deviation of demand fluctuations} \\
D_w(t) &\quad \text{Standard Wiener process (Brownian motion)}
\end{aligned}
$$

- **Inventory Levels:**

$$
\begin{aligned}
I_{\alpha_i}(t) &\quad \text{Inventory level of the } i^{\text{th}} \text{ consumer at time } t \\
I_m(t) &\quad \text{Inventory level of the merchant at time } t
\end{aligned}
$$

- **Costs:**

B_i	Ordering cost per order for the i^{th} consumer
B_m	Ordering cost per order for the merchant
C_c	Purchase cost per unit for the consumers
$\theta_i(t) = \theta_{i0} + \gamma_i \theta_w(t)$	
θ_{i0}	Base deterioration rate
γ_i	Standard deviation of deterioration fluctuations
$\theta_w(t)$	Standard Wiener process (independent of $D_w(t)$)
X_{α_i}	Fixed holding cost per unit time for the i^{th} consumer
Y_{α_i}	Time-varying holding cost for the i^{th} consumer
x_m	Fixed holding cost per unit time for the merchant
y_m	Time-varying holding cost for the merchant
p_i	Selling price per unit for the i^{th} consumer

- **Other Parameters:**

n_i	Number of times the i^{th} consumer orders during the cycle
N	Number of consumers
T	Cycle time (decision variable for the merchant)
$\mathbb{E}[\cdot]$	Expectation operator

2.2 Assumptions

1. **Stochastic Demand and Deterioration:** Demand $D(t)$ and deterioration rate $\theta_i(t)$ are stochastic processes modeled by geometric Brownian motion and mean-reverting Ornstein-Uhlenbeck processes, respectively.
2. **Merchant-Consumer Relationship:** A single merchant supplies multiple consumers.
3. **Inventory Policies:** Shortages and backlogging are not permitted.
4. **Lead Time:** Lead time is negligible or constant.
5. **Replenishment:** Replenishments are instantaneous.
6. **Cost Structures:** Holding costs consist of fixed and time-varying components. Deteriorated items cannot be repaired or replaced during the cycle.

3 Mathematical Model and Analysis

3.1 Stochastic Demand and Inventory Dynamics

The inventory level for each consumer is influenced by stochastic demand and stochastic deterioration rates. The inventory dynamics are described by stochastic differential equations (SDEs).

3.1.1 For Consumers

1. **Inventory Level Equation:**

$$dI_{\alpha_i}(t) = -D(t)dt - \theta_i(t)I_{\alpha_i}(t)dt \tag{1}$$

2. **Demand Process:**

$$D(t) = b_i e^{\alpha_i t}dt + \sigma_i dD_w(t) \tag{2}$$

3. **Deterioration Rate Process:**

$$\theta_i(t) = \theta_{i0}dt + \gamma_i d\theta_w(t) \tag{3}$$

3.1.2 For Merchant

1. **Inventory Level Equation:**

$$dI_m(t) = -\sum_{i=1}^{N} D_i(t)dt \tag{4}$$

3.2 Solving the Stochastic Differential Equations

3.2.1 Consumers' Inventory Levels

The SDE for the i^{th} consumer's inventory level is:

$$\begin{aligned} dI_{\alpha_i}(t) &= -\left[b_i e^{\alpha_i t} + \sigma_i \frac{dD_w(t)}{dt}\right]dt - \left[\theta_{i0} + \gamma_i \frac{d\theta_w(t)}{dt}\right]I_{\alpha_i}(t)dt \\ &= -b_i e^{\alpha_i t}dt - \theta_{i0}I_{\alpha_i}(t)dt - \sigma_i dD_w(t) - \gamma_i I_{\alpha_i}(t)d\theta_w(t) \end{aligned} \tag{5}$$

Assuming that $D_w(t)$ and $\theta_w(t)$ are standard Wiener processes and are independent, the SDE simplifies to:

$$dI_{\alpha_i}(t) = \left(-b_i e^{\alpha_i t} - \theta_{i0}I_{\alpha_i}(t)\right)dt - \sigma_i dD_w(t) - \gamma_i I_{\alpha_i}(t)d\theta_w(t) \tag{6}$$

3.2.2 Solving the SDE

This is a linear SDE of the form:

$$dI(t) = [a(t)I(t) + f(t)]dt + [b_1(t)I(t) + b_2(t)]dW(t) \tag{7}$$

where the stochastic terms represent the multiplicative and additive noise components.

An explicit solution involves advanced stochastic calculus and may require numerical methods or approximations. For the purpose of this paper, we will assume that the inventory level $I_{\alpha_i}(t)$ follows a log-normal distribution, allowing us to compute expected values and variances.

3.3 Expected Costs and Profits

Our objective is to calculate the expected values of costs and profits.

3.3.1 Expected Sales Revenue for Consumers

$$\mathbb{E}[SR_c] = \sum_{i=1}^{N} n_i p_i \mathbb{E}\left[\int_0^{T/n_i} D_i(t)dt\right] \tag{8}$$

Since $D_i(t)$ is stochastic with $\mathbb{E}[D_i(t)] = b_i e^{\alpha_i t}$, we have:

$$\mathbb{E}[SR_c] = \sum_{i=1}^{N} n_i p_i b_i \int_0^{T/n_i} e^{\alpha_i t}dt = \sum_{i=1}^{N} n_i p_i b_i \left[\frac{e^{\alpha_i T/n_i} - 1}{\alpha_i}\right] \tag{9}$$

3.3.2 Expected Holding Cost for Consumers

$$\mathbb{E}[HC_c] = \sum_{i=1}^{N} n_i \left[X_{\alpha_i} \int_0^{T/n_i} \mathbb{E}[I_{\alpha_i}(t)]dt + Y_{\alpha_i} \int_0^{T/n_i} t\mathbb{E}[I_{\alpha_i}(t)]dt\right] \tag{10}$$

3.3.3 Expected Deterioration Cost for Consumers

$$\mathbb{E}[DC_c] = \sum_{i=1}^{N} n_i C_c \mathbb{E}\left[\int_0^{T/n_i} \theta_i(t) I_{\alpha_i}(t)dt\right] \tag{11}$$

3.3.4 Expected Ordering Cost for Consumers

$$\mathbb{E}[OC_c] = \sum_{i=1}^{N} n_i B_i \tag{12}$$

3.3.5 Total Expected Profit for Consumers

$$\mathbb{E}[TP_c] = \frac{1}{T}\left[\mathbb{E}[SR_c] - \mathbb{E}[HC_c] - \mathbb{E}[DC_c] - \mathbb{E}[OC_c]\right] \tag{13}$$

Similarly, the expected profit for the merchant is calculated.

3.4 Optimization

Consumers aim to determine the optimal number of orders n_i, and the merchant aims to determine the optimal cycle time T, to maximize their expected profits:

$$\max_{n_i} \mathbb{E}[TP_c], \quad \max_{T} \mathbb{E}[TP_m] \tag{14}$$

subject to $n_i \in \mathbb{N}^+$ and $T > 0$.

Due to the complexity of the stochastic model, analytical solutions may not be feasible, and numerical methods or simulation techniques are employed.

4 Numerical Example

To illustrate the model, we consider a numerical example with stochastic parameters.

4.1 Given Parameters

- **Demand Parameters:**

$$b_1 = 550, \quad b_2 = 650$$
$$\alpha_1 = 0.055, \quad \alpha_2 = 0.065$$
$$\sigma_1 = 50, \quad \sigma_2 = 60$$

- **Deterioration Parameters:**

$$\theta_{10} = 0.06, \quad \theta_{20} = 0.04$$
$$\gamma_1 = 0.005, \quad \gamma_2 = 0.004$$

- **Holding Costs:**

$$X_{\alpha_1} = 10.5, \quad Y_{\alpha_1} = 0.035$$
$$X_{\alpha_2} = 11.5, \quad Y_{\alpha_2} = 0.045$$
$$x_m = 8, \quad y_m = 0.02$$

- **Costs:**

$$B_1 = 70, \quad B_2 = 100$$
$$B_m = 1600$$
$$C_c = 40$$
$$p_1 = 52, \quad p_2 = 56$$

- **Other Parameters:**

$$N = 2$$
$$T = 10$$
$$n_1 = n_2 = 1$$

4.2 Simulation Approach

Due to the stochastic nature, we use Monte Carlo simulation to estimate expected profits.

4.2.1 Steps

1. **Simulate Demand Paths:** For each consumer, simulate $D_i(t)$ over the interval $[0, T/n_i]$.
2. **Simulate Deterioration Rates:** Simulate $\theta_i(t)$ over the same interval.
3. **Compute Inventory Levels:** Numerically integrate the SDEs to obtain $I_{\alpha_i}(t)$.
4. **Calculate Costs and Revenues:** For each simulation run, compute $SR_c, HC_c, DC_c, OC_c, TP_c, SR_m$
5. **Repeat Simulation:** Perform a large number of simulation runs (e.g., 10,000) to obtain reliable estimates.
6. **Compute Expected Values:** Take the average over all simulation runs to estimate the expected profits.

4.3 Results

Suppose after performing the simulations, we obtain the following estimated expected values:

- **Expected Sales Revenue for Consumers:** $\mathbb{E}[SR_c] = \$850,000$
- **Expected Holding Cost for Consumers:** $\mathbb{E}[HC_c] = \$225,000$
- **Expected Deterioration Cost for Consumers:** $\mathbb{E}[DC_c] = \$120,000$
- **Expected Ordering Cost for Consumers:** $\mathbb{E}[OC_c] = \$170$
- **Expected Total Profit for Consumers:**

$$\mathbb{E}[TP_c] = \frac{1}{10}[850,000 - 225,000 - 120,000 - 170] = \$50,483$$

- **Expected Sales Revenue for Merchant:** $\mathbb{E}[SR_m] = \$630,000$
- **Expected Holding Cost for Merchant:** $\mathbb{E}[HC_m] = \$130,000$
- **Expected Ordering Cost for Merchant:** $\mathbb{E}[OC_m] = \$1,600$
- **Expected Total Profit for Merchant:**

$$\mathbb{E}[TP_m] = \frac{1}{10}[630,000 - 130,000 - 1,600] = \$49,840$$

- **Expected Combined Profit:** $\mathbb{E}[TP] = \mathbb{E}[TP_c] + \mathbb{E}[TP_m] = \$100,323$

5 Sensitivity Analysis

We examine how changes in key parameters affect the expected total profit.

5.1 Parameters Tested

1. **Demand Volatility (σ_i):** Increase and decrease σ_i by 10% and observe the effect on $\mathbb{E}[TP]$.
2. **Deterioration Volatility (γ_i):** Vary γ_i similarly.
3. **Mean Demand Rate (b_i):** Adjust b_i by $\pm 10\%$.
4. **Mean Deterioration Rate (θ_{i0}):** Adjust θ_{i0} by $\pm 10\%$.

5.2 Observations

- **Demand Volatility (σ_i):** Increasing σ_i leads to higher variability in demand, which may result in stockouts or excess inventory. Expected total profit may decrease due to increased holding costs and potential lost sales.
- **Deterioration Volatility (γ_i):** Higher γ_i increases uncertainty in deterioration rates. Expected deterioration costs may increase, reducing profit.
- **Mean Demand Rate (b_i):** Increasing b_i boosts expected sales revenue, enhancing profit.
- **Mean Deterioration Rate (θ_{i0}):** Higher θ_{i0} increases expected deterioration costs, reducing profit.

6 Conclusion

This paper extends traditional inventory models by incorporating stochastic demand and deterioration rates, providing a more realistic framework for managing deteriorating items. The analytical approach, combined with simulation techniques, allows for the estimation of expected profits and the evaluation of optimal policies.

6.1 Key Findings

- Stochastic modeling captures the inherent uncertainties in demand and deterioration, which are critical in perishable inventory management.
- The expected total profit is sensitive to both demand and deterioration parameters.
- Collaboration between merchants and consumers can lead to better inventory policies and higher expected profits.

6.2 Future Research

- **Multiple Replenishment Policies:** Exploring models where orders are placed multiple times within the cycle.
- **Risk Measures:** Incorporating risk measures such as Value-at-Risk (VaR) or Conditional Value-at-Risk (CVaR) in decision-making.
- **Dynamic Pricing:** Integrating dynamic pricing strategies to manage demand uncertainty.

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