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The quality of some approximation formulas in a continuous review inventory model

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October 1985

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Abstract

This paper extends an earlier paper by Heuts and v.Lieshout [3] by representing more extensive information about the quality of some approximation formulas for the reorder point and the order quantity in a continuous review inventory model. Schmeiser and Deutsch [5] introduced the so-called S-D distribution, which we used as lead time demand distribution, as it has many desirable properties. It will be shown that in all cases considered the approximation for the order quantity is an underestimation of the optimal value, while the two approximations for the reorder level are an overestimation of the optimal value. However, what we are really interested in are relevant cost differences between the exact solution method in comparison with approximations. It will be seen that the quality (in terms of cost differences) of the approximation formulas in comparison with exact solutions, very much depends on the following cost ratio: shortage cost p. unit per unit of time in relation to inventory cost p. unit per unit of time.

The quality of one of the two proposed approximations is better than the other for many realistic cost structures. This "best" approximation appears to be a good alternative for the more complex exact solution, when the shortage cost is high in relation to the inventory cost.
1. Introduction

In this paper an inventory model with stochastic lead time demand will be analyzed under the following assumptions:

a. The inventory model is a continuous review system.
b. The order quantity is not restricted.
c. The purchase cost $b(q)$ is a continuous differentiable function of the order quantity $q$.
d. The lead time demand distribution has distribution function $F(z)$.
e. The expected value of the demand per unit of time is $r$.
f. The holding cost per unit inventory per unit of time is $c_1$.
g. Unfilled demand during the lead time is backlogged. The shortage cost per shortage unit per unit of time is $c_2$.

The criterion used is minimization of the average cost per unit ordered.

The cost function looks as follows:

$$K(x, q) = \int_0^x \int_0^y f(z) dz \, dy + \int_y^x \int_q^{\infty} f(z) dz \, dy + \frac{b(q)}{q},$$

where:

- $f(z)$: the density function of the demand during the lead time;
- $x$: the reorder point expressed in terms of units of economic inventory;
- $q$: the order quantity;
- $b(q)$: the ordering cost. We assume that $b(q) = c_0 + q a(q)$, with $a(q)$ a two times differentiable function.

Details of a derivation of (1.1) can be found in Heuts and v. Lieshout [3].

As a density function of the demand during the lead time we have chosen the so-called Schmeiser-Deutsch distribution [5], which is defined in the following way:

$$f(z) = \frac{1}{\lambda_2 \lambda_3} \begin{cases} \frac{1-z}{\lambda_1} & \text{if } 0 \leq z \leq p, \\ \frac{1-\lambda_3}{\lambda_2} & \text{if } \frac{1-\lambda_3}{\lambda_2} \leq z \leq \frac{1-\lambda_3}{\lambda_2}, \\ 0 & \text{otherwise}, \end{cases}$$

where

$$t = \lambda_1 - \lambda_2 \lambda_4, \quad p = \frac{1}{\lambda_1} + \lambda_2 (1-\lambda_4), \quad \lambda_2, \lambda_3 \geq 0, \quad 0 \leq \lambda_4 \leq 1.$$
This four-parameter type of distribution can have many different shapes. Table I shows the relation between the shape of the distribution and the parameters.

Table I: Different shapes for the S-D distribution

<table>
<thead>
<tr>
<th>$\lambda_3 &gt; 1$ (bell-shaped)</th>
<th>$\lambda_3 = 1$</th>
<th>$\lambda_3 &lt; 1$ (U-shaped)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\lambda_4 &lt; 0.5$</td>
<td>skewed to the right</td>
<td>uniform distr.</td>
</tr>
<tr>
<td>$\lambda_4 = 0.5$</td>
<td>symmetric</td>
<td>&quot; &quot;</td>
</tr>
<tr>
<td>$\lambda_4 &gt; 0.5$</td>
<td>skewed to the left</td>
<td>&quot; &quot;</td>
</tr>
</tbody>
</table>

Further it can be shown [5] that $\lambda_1$ and $\lambda_2$ satisfy the following relations:

\[(1.3) \quad \lambda_2 = \frac{\sigma^2 (2\lambda_3 + 1)(\lambda_3 + 1)^2}{(\lambda_3 + 1)^2 \lambda_4 + (1 - \lambda_4) \lambda_3 + 1} - (2\lambda_3 + 1)(1 - \lambda_4) \lambda_3 + 1 - \lambda_4 \lambda_3 + 1 - \lambda_4 \lambda_3 + 1 - \lambda_4 \]

\[(1.4) \quad \lambda_1 = \mu - \lambda_2 \frac{\lambda_3 + 1}{\lambda_3 + 1} - \lambda_4 \]

These results will be used in section 3. The reason why we have chosen the S-D distribution is because of the following interesting properties: The distribution function, the inverse distribution function and the conditional expectations can be determined explicitly.

Using gamma, Weibull or beta distributions, evaluation of the cost function would require evaluation of incomplete gamma or beta functions, which is troublesome (see e.g. Kottas and Lau [4], Tadikamalla [6] and Burqin [2]).

As the S-D distribution has four parameters, different types of skewness can be better described than two-parameter distributions, such as the Weibull or the gamma distribution. The importance of the type of skewness...
on the cost function will be demonstrated in a next paper.
In [3] a solution procedure for the model with cost function $K(x,q)$ given by (1.1) and as lead time demand distribution the S-D distribution is given.
The optimization method used is a Newton-like algorithm.
2. Approximation formulas for the reorder point and order quantity

A simple approximation for the order quantity is the well-known lot size formula:

\[ q_0 = \left( \frac{2cr}{c_1} \right) \]

whereas for the reorder point \( x \) two approximations are used. The first one is based on the fact that the service level \( \alpha \) is defined as the probability that the demand during the lead time is smaller than the order level:

\[ F(x) = \alpha = \left( \frac{c_2}{c_1 + c_2} \right) \]

Remarkable upon these approximation formulas is, that they are completely independent of each other.

Baken [1] has shown that this independent calculation of \( x \) and \( q \) will lead to inferior quality of these variables in certain cases.

A second set of approximation formulas for \( q \) and \( x \), which is dependent of each other, is:

\[ q_0 = \left( \frac{2cr}{c_1} \right) \]

\[ \frac{1}{q_0} \int_{x_2}^{\infty} (z-x_2)f(z)\,dz = \frac{c_1}{c_1 + c_2} \]

where (2.4) means that the fraction expected shortages with regard to the total sales per order cycle is equal to \( 1 - \alpha = \frac{c_1}{c_1 + c_2} \), where \( \alpha \) is the service level.

It will be shown that if \( f(z) \) is a S-D distribution, then the following dependence between \( x \) and \( q \) exists:

If the order quantity \( q_0 \) increases, then the order point \( x_2 \) decreases, because of the fact that the value of the integral in (2.4) is non-increasing as function of \( x_2 \).

Equation (2.2) is equivalent with (see e.g. Schmeiser-Deutsch [5]):

\[ x_1 = \begin{cases} \frac{x - x_2}{4} - \frac{c_2}{c_1 + c_2} \frac{x}{4} & \text{if } \frac{c_2}{c_1 + c_2} < \frac{x}{4} \\ \frac{x + x_2}{4} - \frac{c_2}{c_1 + c_2} \frac{x}{4} & \text{if } \frac{c_2}{c_1 + c_2} > \frac{x}{4} \end{cases} \]
The integral in equation (2.4) can be written as
\[ \int_{x_2}^{\infty} (z-x_2)f(z)dz = G(x_2) = \frac{x_2}{l_1 + \frac{l_2}{l_3+1} \{(1-l_4)^{l_3+1} - l_4^{l_3+1}\}} - x_2 = \mu - x_2 \text{ for } x_2 \leq t \]

i) \[ \frac{l_2}{l_3+1} \{(1-l_4)^{l_3+1} - l_4^{l_3+1}\} - x_2 = \mu - x_2 \text{ for } x_2 \leq t \]

ii) \[ l_1(1-l_4) + \frac{l_2}{l_3+1} (1-l_4)^{l_3+1} + x_2(l_4-1) + \frac{l_2}{l_3+1} \frac{l_1-x_2(l_3+1)}{l_3+1} \]

for \( t \leq x_2 \leq l_1 \)

iii) \[ l_1(1-l_4) + \frac{l_2}{l_3+1} (1-l_4)^{l_3+1} + x_2(l_4-1) + \frac{l_2}{l_3+1} \frac{x_2(l_3+1)}{l_3+1} \]

for \( l_1 \leq x_2 \leq p \)

iv) \[ 0 \text{ for } x_2 \geq p \]

Properties of \( G(x) \):

a) \( G(0) = \mu \)

b) \( G(x_2) = 0 \text{ for } x_2 \geq p \)

c) \( G(x_2) \) is a decreasing function of \( x_2 \) on the interval \([0,p)\).

On the intervals \([0,t]\) and \([t, l_1]\) this is trivial as \( (l_4-1) < 0 \).

On the interval \([l_1,p]\) it follows from the inequality:
\[ \frac{\partial G(x_2)}{\partial x_2} = (l_4-1) + \frac{x_2-l_1}{l_2} \frac{1}{l_3} < (l_4-1) + \frac{p-l_1}{l_2} \frac{1}{l_3} = 0 \]
because \( p = l_1 + \frac{l_2}{1-l_4} \).

So on the interval \( x_2 \in [0,p] \) the function \( G(x) \) is uniquely reversable, which means that the inverse function of \( G(x_2) \) exists. However, the inverse function is not easily calculated. For the determination of \( x_2 \)
we therefore used procedure C05ADF from the NAG-library, which calculates the zero point of a function via a search procedure.
3. Some results on the quality of the two sets of approximation formulas

In this section we will investigate the quality of the approximation formulas, which we have defined in section 2. The first set of approximation formulas in equations (2.1) and (2.2) will be denoted by $q_0$ and $x_1$, the second one (see equations (2.3) and (2.4)) by $q_0$ and $x_2$, and the optimal solution will be denoted by $q^*$ and $x^*$. For the cost function the following notations are used:

\[ K_1 := K(x_1,q_0) \quad \text{red} 1 := \frac{K(x_1,q_0) - K(x_2,q_0)}{K(x_1,q_0)} \times 100 \]

\[ \text{red} * := \frac{K(x_2,q_0) - K(x^*,q^*)}{K(x_2,q_0)} \times 100. \]

In the next tables the following variables are held constant:
- the mean and variance of the demand during the lead time $(\mu = 100 \text{ and } \sigma^2 = 600)$
- the demand per unit of time and the holding cost per unit of inventory $(r = 100 \text{ and } c_1 = 1)$.

The shape parameters $l_3$ and $l_4$ are varied together with the cost parameters $c_0$ and $c_2$. The variation in the shape parameters is denoted as follows:

(1) $l_3 = 0.4 \land l_4 = 0.2$  (2) $l_3 = 0.4 \land l_4 = 0.8$

(3) $l_3 = 1.8 \land l_4 = 0.2$  (4) $l_3 = 1.8 \land l_4 = 0.8$

Table II contains information about the reorder points, Table III about the order quantities and Table IV about the cost differences.
Table II: Decisions on the reorder points

<table>
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<td>$x_1$</td>
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<td>90.7</td>
<td>91.4</td>
<td>108.6</td>
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<td>$x_2$</td>
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<td>77.9</td>
<td>78.2</td>
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<td>141.5</td>
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<tr>
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<tr>
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<td>141.5</td>
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<td>88.0</td>
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<td>152.4</td>
<td>155.2</td>
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<tr>
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<td>138.2</td>
<td>134.6</td>
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Table III: Decisions on the order quantities

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<td>44.7</td>
<td>44.7</td>
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<tr>
<td>( q_0 )</td>
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<td>44.7</td>
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<td>44.7</td>
<td>44.7</td>
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<tr>
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<td>47.5</td>
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<td>( q_0 )</td>
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<td>141.4</td>
<td>141.4</td>
<td>141.4</td>
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<td>167.0</td>
<td>164.0</td>
<td>154.7</td>
</tr>
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<td>( c_0 = 100 ), ( c_2 = 100 )</td>
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<tr>
<td>( q_0 )</td>
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<td>141.4</td>
<td>141.4</td>
<td>141.4</td>
</tr>
<tr>
<td>( q^* )</td>
<td>144.5</td>
<td>146.8</td>
<td>149.0</td>
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</table>
### Table IV: Cost differences for the resp. decisions

<table>
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<td></td>
<td></td>
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<tr>
<td>$K_1$</td>
<td>0.5511</td>
<td>0.4912</td>
<td>0.4904</td>
<td>0.5508</td>
</tr>
<tr>
<td>redL</td>
<td>20.2</td>
<td>9.3</td>
<td>7.9</td>
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<td>redX</td>
<td>9.5</td>
<td>10.7</td>
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<tr>
<td>$K_1$</td>
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<tr>
<td>$K_1$</td>
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<td>1.8832</td>
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<td>redX</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
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</table>

Preliminary conclusions drawn from tables II, III and IV:
1) The second set of approximations is better than the first one:
   \[ K(x_2,q_0) < K(x_1,q_0) \text{ or } \text{red}1>0. \]
2) The approximation $x_2$ for $x^*$ is better than $x_1$, or
   \[ |x_2-x^*| < |x_1-x^*|. \]
3) The approximation for $q^*$ is an underestimation:
   \[ q_0 < q^*, \text{ which improves when } c_2 \text{ increases.} \]
4) The approximations for $x^*$ are an overestimation:
   $x_1 > x^*$ and $x_2 > x^*$, and they improve when $c_2$ increases.

5) The approximation $(x_2, q_0)$ improves:
   - when the order cost $c_0$ increases
   - when the shortage cost $c_2$ increases.

6) The influence of the cost parameters on the quality of the approximation formulas is much more important than the influence of the shape of the probability distribution.

Some comments
- When the shortage cost is relatively high, then the tail behaviour for large values of the probability distribution is an important factor. In the second approximation formula for $x^*$, this factor is better incorporated than in the first one, explaining the results in the tables.
- When the shortage cost is relatively low, then the tail behaviour of the low values of the probability distribution is an important factor. This aspect is not incorporated in any of the approximation formulas. The mentioned approximation formulas for $x^*$ are not suitable when the inventory cost p.unit p.unit of time is relatively high.

As the above results are only based on a limited number of examples, we further investigated the quality of the approximations for a more diversified number of cost structures. It then follows that the preliminary conclusions under points 3) 4) and 5), which describe the relation between the cost parameters and the quality of the approximation formulas, are not valid in general.

In tables V and VI examples are given to illustrate this. However the question arises if all supposed cost structures there are realistic.
In tables V and/or VI the symbols in the respective columns are defined as follows:

\begin{align*}
  dx_1 & := \frac{(x_1 - x^*)}{x^*} \cdot 100\% \\
  dx_2 & := \frac{(x_2 - x^*)}{x^*} \cdot 100\% \\
  dq_0 & := \frac{(q^* - q_0)}{q^*} \cdot 100\% \\
  dK_1 & := \frac{(K(x_1, q_0) - K(x^*, q^*))}{K(x^*, q^*)} \cdot 100\% \\
  dK_2 & := \frac{(K(x_2, q_0) - K(x^*, q^*))}{K(x^*, q^*)} \cdot 100\% \\

\end{align*}

\( x^*, q^* \) optimal decision variables

\( K^* := K(x^*, q^*) \) minimal cost function

\begin{align*}
  dx_2 q^* & := \frac{(x_2(q^*) - x^*)}{x^*} \cdot 100\% \\

\end{align*}

where \( x_2(q^*) \) is the approximation for \( x^* \) via (2.4), however with the optimal \( q, q^* \) substituted in it.

\begin{align*}
  dKx_2 q^* & := \frac{(K(x_2(q^*), q^*) - K(x^*, q^*))}{K(x^*, q^*)} \cdot 100\% \\
  dKx_0 q^* & := \frac{(K(x^*, q_0) - K(x^*, q^*))}{K(x^*, q^*)} \cdot 100\% \\

\end{align*}

\( vx_1 := x_1 - x^* \)

\( vx_2 := x_2 - x^* \)

When \( x^* = 0.0 \), \( dx_1 \) and \( dx_2 \) do not exist.

In those cases absolute differences are given:

\begin{align*}
  dx_1 & := |x_1 - x^*|, \quad dx_2 := |x_2 - x^*| \\

\end{align*}

Conclusively we can state that the quality of the proposed approximations strongly depends on relative costs \( p \) unit per unit of time as can be seen from the tables.
Table V: The influence of $c_2$ on the quality of the approximation formulas by different values of $c_0$ and $c_1$

<table>
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<tr>
<th>$c_0$</th>
<th>$c_1$</th>
<th>$c_2$</th>
<th>$dx_1$</th>
<th>$dx_2$</th>
<th>$dq_0$</th>
<th>$dK_1$</th>
<th>$dK_2$</th>
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<th>$q^*$</th>
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<td>17.38</td>
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- $\mu = 100$
- $\sigma^2 = 600$
- $\lambda_3 = 1.8$
- $\lambda_4 = 0.2$
Table VI: The influence of $c_0$ on the quality of the approximation formulas by different values of $c_1$ and $c_2$

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<td>0.00</td>
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</table>

* does not exist
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