

360-390 words

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Abstract: Inventory is expensive, so it needs to be as lean as possible without compromising revenue and customer service. This article provides some suggestions to help businesses trim the fat from inventory and some useful inventory ratios for benchmarking and evaluating product mix.

Too much inventory at your business? Trim the fat!

Businesses need to have inventory on hand. But having excess inventory is expensive, so it's important to keep it as lean as possible. Here are some ways to trim the fat from your inventory without compromising revenue and customer service.

Accuracy first

Effective inventory management requires starting with an accurate physical inventory count. That allows you to determine your true cost of goods sold — and to identify and remedy discrepancies between your physical count and perpetual inventory records. A CPA can introduce an element of objectivity to the counting process and help minimize errors.

Next, compare your inventory costs to those of other companies in your industry. Trade associations often publish benchmarks for:

- Gross margin ($(\text{revenue} - \text{cost of sales}) / \text{revenue}$),
- Net profit margin ($\text{net income} / \text{revenue}$), and
- Days in inventory ($\text{annual revenue} / \text{average inventory} \times 365 \text{ days}$).

Your company should strive to meet — or beat — industry standards. For a retailer or wholesaler, inventory is simply purchased from the manufacturer. But the inventory account is more complicated for manufacturers and construction firms. It's a function of raw materials, labor and overhead costs.

The composition of your company's cost of goods will guide you on where to cut. In a tight labor market, it's hard to reduce labor costs. But it may be possible to renegotiate prices with suppliers.

Don't forget the carrying costs of inventory, such as storage, insurance, obsolescence and pilferage. You can also improve margins by negotiating a net lease for your warehouse, installing antitheft devices or opting for less expensive insurance coverage.

Product mix

Cutting your days-in-inventory ratio should be done based on individual product margins. Stock more products with high margins and high demand — and less of everything else. Whenever possible, return excessive supplies of slow-moving materials or products to your suppliers.

Product mix should be sufficiently broad and in tune with consumer needs. Before cutting back on inventory, you might need to negotiate speedier delivery from suppliers or give suppliers access to your perpetual inventory system. These precautionary measures can help prevent lost sales due to lean inventory.

Reality check

Often, managers are so focused on sales, HR issues and product innovation that they lose control over inventory. Contact us for a reality check.