

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 their mix of products.

Keep control over inventory at your business

Many businesses need to have some inventory available. But having too much inventory is expensive — not just to purchase but to store, safeguard and insure. So, keeping your inventory as lean as possible is critical. One rule of thumb says the expense of maintaining stock in inventory averages about 2% of the cost of goods sold, for each month items aren't sold. That means if your business carries an item for a year, you may be down 24%. That's hard to overcome, especially in tough times.

Here are some ways to trim the fat from your inventory without compromising revenue and customer service.

Where to begin

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 try 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 and opting for less expensive insurance coverage.

More steps to take

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

Product mix should be sufficiently broad but still in tune with the needs of your customers. Before cutting back on inventory, you should try 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.

Take inventory of inventory

It's easy for inventory to get lost in the shuffle when you and your leadership team are facing big-picture issues such as strategic planning, innovation and compliance. Managers are often so focused on sales that it becomes easy to lose control. Contact us for help managing your inventory.