

Abstract: Inventory is expensive, so it needs to be as lean as possible. Businesses need to find ways to trim the fat from inventory without compromising revenue and customer service. This article has some suggestions, including using inventory ratios for benchmarking and reviewing product mix.

How to trim the fat from your inventory

Inventory is expensive, so it needs to be as lean as possible. Here are some ways to trim the fat from your inventory without compromising revenue and customer service.

Objective inventory counts

Effective inventory management starts with a physical inventory count. Accuracy is essential to knowing your cost of goods sold — and to identifying and remedying 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.

The next step is to 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.

And 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

To cut your days-in-inventory ratio, compute product-by-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 management is so focused on sales, HR issues and product innovation that they lose control over inventory. Contact us for a reality check.

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