

# Panning For Your Business Gold Mine . . . Inventory Control

by Terry Soifer  
Consulting CFO, Inc.

In our last article about asset management, we discussed Accounts Receivable. The other current asset that I would like to review is Inventory. **Inventory** includes our investment in raw materials, work in process, finished goods and supplies. The key in managing inventory is to balance the cost and risk of carrying inventory against the benefits derived from having the inventory available. This cost/benefit relationship is extremely important when you are dealing with products that are subject to obsolescence or perishability.

Some strategies companies use to control their inventory are:

1. Establish minimums and maximums for major items. Some of the factors to consider in this analysis are: number of units sold or anticipated being sold; the number of targeted inventory turns; availability of product from suppliers; production capability of manufacturers, and other factors.

2. Calculate an economic order quantity. How many units should be ordered? When making this decision, consider consumption patterns, availability of vendor products, cost to handle and store product, obsolescence, perishability, vendor discounts/pricing, etc.

3. Take advantage of competitive and special buy situations. When food manufacturers are having a sales promotion, retail food chains

take advantage of this by purchasing large quantities of product for those items with high turnover rates. The result will be an improvement in profitability.

---

---

*The key in managing inventory is to balance the cost and risk of carrying inventory against the benefits derived from having the inventory available.*

---

---

4. Just-in-time is a relatively new strategy that the automotive industry uses very effectively and could be used by any business that has inventory. This strategy shifts the cost of carrying inventory to the supplier. Automotive companies require their main suppliers to locate their plants in close proximity to their production facilities. Why? Because when they need their supplier's product, they know that their suppliers can have the product at the production site in one or two days. The result of this decision is that the automotive manufacturers have shifted the cost of carrying this inventory to their suppliers and have freed up sizeable portions of their own working capital.

Like accounts receivable, there are several methods that can be used to measure the effectiveness of your inventory program. The method

most commonly used is inventory turnover, which is calculated by dividing your cost of goods sold by your average value in inventory.

Again, now that you understand the basics, let's look at an example. Assume the following for company XYZ:

---

Inventory balance at 12/31/89 is \$525,000 and at 12/31/90 it is \$450,000.

Turnover	Firm	Industry
1989	1.5	2.5
1990	1.5	2.5

---

What is this information telling us?

1. While the inventory value decreased by \$75,000, the number of inventory turns did not increase. Therefore, since the number of turns is based on the relationship of cost of goods sold to inventory, we know that sales have been decreasing at the same time as inventory.

2. By using the formula for inventory turns and extrapolating this data, increasing the number of turns to the industry average could increase cash availability by about \$195,000. (This certainly would be a nice increase in working capital.)

But what the data does not tell is also important. Some of the reasons for the inability to further reduce inventory are: 7% of inventory is obsolete and 4% is for specific customers who are no longer in business. Again, looking underneath the numbers gives the numbers an entirely new meaning.

---

---

### **Summary**

We have now finished looking at sales, costs, accounts receivable, and inventory. What we have learned is that there is no magic which will help us find the gold mine in our business: **only hard work**. Part of that work needs to concern itself with:

1. Defining the critical parameters required to analyze your business.

2. Implementing Management Information

Systems (manual or computerized) that will give you the information you need.

3. **Analyzing** both sales and expenses.

4. Challenging yourself to find new ways to do things.

5. Investing capital in your business to reduce costs and increase productivity, when economically viable.

6. Avoiding the tendency to just look at balance sheet totals. Look underneath to see what is really happening and why.

7. Listening to your employees. They are your best source of new ideas and profits.

---

---

---

---

*This is the last of a four-article series available from Consulting CFO, Inc. Other topics include: asset management, expense reduction and sales analysis. For additional articles, or for additional reprints of this article, contact Terry Soifer, President, Consulting CFO, (407) 628-5534.*