

Inventory: Friend or Foe?

By Rebecca A. Morgan
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Poor inventory management is a bête noire of profitable businesses, leading financial auditors and bankers to cast a wary eye. You should too.

You've seen "Going Out of Business; Everything MUST Go!" signs in a storefront window. You may know a business that struggles to meet payroll while dust collects on languishing inventory. Yet some of you can tell stories about the big sale made possible by having just what the customer needed sitting in inventory ready to go. Is inventory the business owner's best friend or ominous foe?

In accounting, inventory is considered an asset. So is cash. But cash allows you to make payroll, and as they say, buy a cup of coffee. Inventory does not. The goal is to tie up as little cash as possible in inventory, while having enough inventory to meet business needs. Poor inventory management is a bête noire of profitable businesses, leading financial auditors and bankers to cast a wary eye. You should too.

There are two primary reasons why companies have inventory. The first, true for every business, is to decouple demand from supply. What does that mean? It means you'd rather not go to the store each time you need a sheet of paper for your printer. You want your demand for paper to be met through a convenient in-house inventory. But you don't want to keep a lifetime supply of paper in your office. There is a trade-off point where it begins to cost more to carry the inventory than it costs to not carry the inventory.

Inventory management is about figuring out where that point is, and then figuring out how to reduce it. That same thinking is relevant to manufacturing inventories, to hair care supplies for stylists, to gauze and pharmaceuticals for hospitals. And to your business.

Retailers have a second reason to invest in inventory. For them, inventory not only decouples demand and supply, but is also part of a marketing strategy to create or shift demand. Impulse items stocked by checkout registers in grocery stores are placed there to encourage you to buy things not likely to be on your list. Department stores offer choices with the intent of persuading shoppers to purchase on the spot.

Regardless of the intent of inventory, the decision of what and how much to carry should balance the cost of carrying inventory with the cost of not carrying inventory. The cost to carry inventory includes, among other things:

- Storage
- Insurance
- Risk of obsolescence
- Damage
- Inventory taxes
- Opportunity costs

The most important cost of carrying inventory is usually the opportunity cost, or the value of what you could have done with the money if you hadn't spent it on inventory. Whether it is invest in training, capital equipment, more salespeople, or simply put it in a savings account, there is something else you could have done with that money. The gains you could have enjoyed from those other investments are a cost of carrying inventory. You must expect your inventory to give you a higher rate of return than you would have received from those other investments, or you would have invested in them instead of in inventory.

The cost of not having inventory is typically related to service level and lost sales. Look at your business and ask, "What would happen if I didn't carry any inventory at all?" Start there because that is where no cash is required for inventory. As you move up the scale to consider higher and higher quantities of inventory of a given item, you will reach a quantity where you determine that it is cheaper not to stock that next piece of inventory than to have it.

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Once you've determined your optimal inventory levels, work to lower those numbers. After all, you would rather have fully flexible cash than less flexible inventory. There are numerous methods to reduce inventory levels without negatively impacting service, including reducing lead times, more frequent deliveries, and reducing container quantities. Vendor managed inventory (think the bread man at a grocery store) and consignment are just two methods of working with suppliers to manage inventories.

The science of inventory management is well developed and continues to mature. The key word is "management." Start by paying close attention to how much money you have tied up in inventory and frequently review the question: "Is my current inventory friend, or foe?" Then ask the question "How can I reduce the money tied up in inventory while improving service levels to customers?" There are answers, but only if you ask the questions.



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