20. Inventory Management

The best run companies will minimize their investment in inventory. Inventory is costly and involves the potential for loss and spoilage. In the alternative, being out of stock may result in lost customers, so a delicate balance must be maintained. Careful attention must be paid to the inventory levels. One ratio that is often used to monitor inventory is the Inventory Turnover Ratio. This ratio shows the number of times that a firm's inventory balance was turned ("sold") during a year. It is calculated by dividing cost of sales by the average inventory level:

Inventory Turnover Ratio
=
Cost of Goods Sold/Average Inventory

If a company's average inventory was $1,000,000, and the annual cost of goods sold was $8,000,000, you would deduce that inventory turned over 8 times (approximately once every 45 days). This could be good or bad depending on the particular business; if the company was a baker it would be very bad news, but a lumber yard might view this as good. So, general assessments are not in order. What is important is to monitor the turnover against other companies in the same line of business, and against prior years' results for the same company. A declining turnover rate might indicate poor management, slow moving goods, or a worsening economy. In making such comparisons and evaluations, you should now be clever enough to recognize that the choice of inventory method affects the reported amounts for cost of goods sold and average inventory. As a result, the impacts of the inventory method in use must be considered in any analysis of inventory turnover ratios.