Inventory Turns

by George Matyjewicz

With any distribution business, the less money you have tied up in inventory in order to fill your distribution channels, the more money you will have to do all the other things a company needs done -- marketing, advertising, research and development, acquisitions, expansions, and so on. You need to turn your inventories as often as possible during the year in order to free up that working capital to do other things.

The “official” calculation to figure out how you are turning inventory, is to first find out the Cost of Goods Sold (COGS) for the past 12 months. Then take the current inventory and divide it by the Cost of Goods Sold and you get the number of times you have turned inventory.

Retailers, who used to work on the "Retail Method of Accounting", traditionally calculated the number of turns of inventory by adding beginning RETAIL value of your inventory to the RETAIL value of your purchases then subtracting the RETAIL value of the ending inventory, then divided that value by your total sales. This method has been used in the past because the retailers, on the advice of their accountants, used retail values as it was too difficult to calculate costs manually. But that assumes that everything you sell will be at the retail value. Now, with a good Inventory Control system you will obtain a true Cost of Sales. Hence, you should use the COST instead of Retail to produce a more accurate picture of your inventory turns:

((Beg.Inv.at Cost) + (Purchases at Cost) - (Ending Inv. at Cost)) / (Cost of Sales)

If your Inventory system also has a method of tracking adjustments for shrink or scrapped items, then the more accurate formula would be: ((Beg.Inv) + (Purchases) - (Ending Inv.) - (Cost of Scrapped and Lost items)) / (Cost of Sales)

Turns refer to the number of times your inventory is replaced per year OR per month. The turns can be calculated for the whole inventory or part of the inventory such as a department or product grouping and gives you a picture of the business compared to the last month, quarter, season or year, and how you compare to others in your industry. The higher the number of turns, the better you are doing and the more productivity you are getting from your inventory investment, Return On Investment (ROI). If two companies are the same in every way but one is turning over its inventories more often, the one with better inventory management is the one that is going to be able to grow faster. Inventory management actually is a bottleneck for growth if it is not efficient enough, tying up a lot of working capital that could be better used elsewhere.

There is a fine line between a high number of turns and running out of product because your inventory is too close to what you are selling AND having too much inventory compared to your sales- When you get your inventory to the correct levels then you have achieved Just-in-Time Inventory. There is a critical mass point where the amount of inventory on hand will earn the best return. For example, if you had $1 million in inventory, and you only had sales of $100,000 in a month, you would have too much inventory and not make the turns. On the other hand, if you had $10,000 in inventory and $100,000 in sales, you would be buying too often and losing out on inventory turns. The ideal point is to turn inventory 5-6 times, and it is possible to turn it 10-12 times as many companies do. There are many factors which influence inventory turns, including how quickly you can replenish.

Your goal is to keep your inventory investment at target levels with as wide a selection as possible.
Financial advisors Motley Fool believes inventory is a liability masquerading as an asset, especially with retailers. Inventory represents the merchandise the company has available for sale. For most retailers, this is finished goods sitting in warehouses or on store shelves.

The reason they consider this a liability is because of inventory risk. Essentially, inventory risk is the risk that the value of the inventory will decline before it's sold. The problem that many retailers face is that their goods are perishable, either literally in the sense of food spoiling, or theoretically in the sense that items could go out of fashion.

How big is this risk? It depends on the type of retailer. For retailers that sell fashionable items, this risk is significant. If they cannot sell products when they are "hot," it will be hard if not impossible to sell them at full price in the future. The result is lower prices or "markdowns" on the inventory to entice customers to buy the merchandise. Because of the lower prices, the company will make less money, thus profits fall.

Furthermore, when it comes time to buy merchandise for the next season, the retailer finds itself a bit short of cash. In fact, the retailer could decide to buy fewer items next time to hedge against inventory risk. The point here is that high levels of inventory are often a leading indicator of problems for a retailer.

Many industries and companies use GMROI (Gross Margin Return on Investment) which is a merchandise planning and decision making tool that assists buyers in identifying and evaluating whether an adequate gross margin is being earned by the products purchased, compared to the investment in inventory required to generate those gross margin dollars. This is very common in the fashion industry, where merchandise is replaced every season.

For every dollar of inventory investment GMROI will help you calculate your return. The industry may average $2.00 return for every inventory dollar, however, some retailers, however are getting $4, $5 or more.

GMROI reveals where actual dollar profits (versus paper profits) are attained in the merchandise plan. It focuses the buyers' attention on return-on-investment rather than sales as a basis for merchandising decisions.

To calculate GMROI, follow these steps:

1. Calculate your gross margin or realized gross margin as a percentage.
2. Calculate the value of your average inventory at cost.
3. Divide your total sales by your average inventory at cost. This will give you your ratio of sales to inventory investment.
4. Multiply the result of #3 by your gross margin percentage (#1) to get GMROI.

GMROI works for any size store, department or merchandise classification. It will work for each category in each department, each class in each category, each color, each size in each class and so on.

Managing your GMROI results will enable your inventory to work for you and generate increased profits.

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