

What is Inventory Shrinkage & How Do You Reduce It?



One of the occasionally frustrating concerns faced by every business is managing inventory effectively.

But for many companies, the most challenging part of inventory management isn't dealing with what's on hand, but what *isn't*.

Experiencing *inventory shrinkage*, or the loss of inventory for various reasons, not only creates a potential accounting headache, but can eat away at your profits and put your bottom line, or even your business, in harm's way.

Inventory Shrinkage Defined

You've likely seen it before: your inventory list records 4,000 X-brand widgets on hand, but a physical count in the warehouse reveals you've got just 3,978.

A small discrepancy, but one that adds up across locations, product lines, and time.

Whenever your business loses inventory, for whatever reason, you've experienced inventory shrinkage.

Also called *shrinkage* or even just *shrink*, this discrepancy is a normal and expected part of doing business—but at high levels, it can be a sign of serious underlying problems within your company.

How much is too much? The answer varies by both industry and by individual business, but the easiest, and most effective, approach to inventory management is to simply keep inventory shrinkage as low as possible at all times.

Common Causes of Inventory Shrinkage

When physical inventory counts don't match accounting records, it's likely due to one of three common causes:

- *Physical goods may break.* Perishable goods can spoil. Some items may have important components evaporate literally into thin air, rendering them unusable for their original purpose and unsalable to your customers.
- *Paperwork Errors.* Staff miscounts, vendor clerical errors, or mislabeled goods (e.g., incorrect quantities) can create a mismatch between your inventory records and goods on hand.
- *Shoplifting* (retail theft), employee theft/employee inventory theft, and vendor fraud can all deplete your actual inventory. Supplier fraud is especially dangerous for small businesses who count on receiving all the goods they've paid for in order to sustain their growth in the early years of their existence, and may not have the resources necessary to compensate for undetected fraud perpetrated by a vendor who overbills and underships regularly.

How to Calculate Inventory Shrinkage

The metric used to measure inventory shrinkage is known as your *inventory shrinkage rate*.

Expressed as a percentage, your inventory shrinkage rate tells you just how much you've lost to theft, fraud, errors, and damage.

Keeping this percentage low is essential to keeping your inventory levels where

they should be—and your profits on the grow.

To calculate your inventory shrinkage percentage:

1. Conduct a physical inventory count.
2. Calculate the value of the inventory on hand.
3. Subtract this amount from the inventory amount listed in your accounting records.
4. Divide the difference (if any) by the inventory amount to obtain the inventory shrinkage rate.

For example:

Let's say your company has \$100,000 worth of Widget inventory listed in your books.

After you perform a physical inventory, you find the amount you actually have on hand is \$97,500, giving you an inventory shrinkage total of \$2,500.

$$\textbf{\$100,000 - \$97,500 = \$2,500}$$

Divide the shrinkage by the total recorded inventory to get:

$$\textbf{\$100,000 \div \$2,500 = .025}$$

Expressed as a percentage (i.e., multiplying the quotient by 100), your total inventory shrinkage is **2.5%**.

Fighting Inventory Shrinkage

Once you know how much shrinkage you're dealing with, the next step is to take measures to reduce it.

How much is too much? The answer varies by both industry and by individual business, but the easiest, and most effective, approach to inventory management is to simply keep inventory shrinkage as low as possible at all times.

This will not only minimize your losses, but help you find and take advantage of opportunities to further refine, streamline, and standardize your production, supply, and sales processes.

You can combat inventory losses in a number of ways:

- **Integrate With Automation**

You can greatly simplify your inventory and supply chain management by installing a one-stop software package that automates critical everyday procurement functions. Generating complete data for existing inventory, production resources, and transactional information can help you spot the areas where you're losing valuable inventory to fraud, theft, or human error.

- **Make Verification a Standard Part of Your Receiving Procedure**

This is greatly simplified with automation software, which can link shipping documents to purchase orders and automatically provide verification that quantities received match quantities ordered.

- **Get Team Buy-in**

Use training and policy to create an environment where every staff member is aware of inventory loss and measures necessary to reduce it. Train your staff on the safest way to handle inventory to prevent needless losses to damage, spoilage, or clerical errors.

- **Be Proactive With Regard to Shoplifters**

If you have a retail business, make sure your staff are trained to look for signs of shoplifting, fraud, and other duplicity. If necessary, change your return policy to discourage opportunists and prevent the return of stolen goods, regardless of point of sale.

- **Conduct Inventory Regularly**

If you have a software solution in place, you can identify errors or malfeasance early, before they become a crisis. This also makes it much easier to monitor inventory shrinkage rate in real time as well as for pre-

defined accounting periods.

Don't Let Shrinkage Keep You From Growing

The loss of inventory may be nigh unavoidable in an imperfect world, but that doesn't mean you have to let it cut too deeply into your bottom line.

With time, dedication, and the right tools, you can move beyond simple awareness of your losses and use inventory management techniques to create a strong defense against inventory losses due to damage, theft, and administrative errors.

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