Inventory Turnover Ratio And How To Calculate It

Managing inventory levels is crucial for a company to determine whether their sales efforts are effective and whether costs are under control.

The inventory turnover ratio serve as an important measure of how well a company is generating sales from inventory.

What is Inventory?

Inventory is the account of all goods the company has in stock whether it is raw materials, work in progress materials for finished goods to be sold. Inventory generally includes finished goods, such as clothing in a department store.

However, inventory may also include dry materials that go into the production of the finished goods, known as work-in-progress. For Instance, the cloth a manufacturer uses to make clothing is considered inventory for the manufacturer.

What is Inventory Turnover?

Inventory turnover refers to the number of times an organization sells and

replenishes their amount of inventory over a period of time.

Inventory turnover gives insight into how the company manages costs and how effective their sales efforts have been.

How Inventory Turnover is Interpreted

The higher your inventory turnover, the better, because that means your company is selling goods quickly and there is product demand.

A low inventory turnover ratio means weaker sales and declining product demand.

Your inventory turnover ratio also shows whether your sales and purchasing departments are working in sync. In the ideal business environment, inventory matches sales.

It costs money to store inventory that’s not selling, so inventory turnover is a strong indicator of how effective sales efforts are, but crucial to helping manage operating costs.

Using less inventory to achieve a higher number of sales improves inventory turnover.

> *To determine if your company is properly managing stock, you need to look at the inventory turnover ratio. If you overestimate the demand for products and purchase too many goods, that’s shown in low turnover. On the other hand, if your inventory turnover is high, you may not be able to buy enough inventory and as such miss out on sales.*

How to Calculate Inventory Turnover Ratio

Inventory turnover ratio looks at how much inventory is sold over a period of time.

To calculate your inventory turnover ratio, divide the cost of goods sold by the

average inventory for the same period of time.

The inventory turnover formula is:

Cost of Goods Sold (COGS) / Average Inventory

The ratio uses average inventory because companies may have higher or lower inventory levels depending on the time of the year.

For instance, retailers such as Walmart are more likely to have higher inventory levels in Q4 as they prepare for holiday shopping, and lower levels in Q1 because the holidays are over.

COGS refers to a measurement of production costs related to the goods and services a company provides.

It includes the cost of materials, labor costs associated with the goods produced, along with overhead and fixed costs that are directly involved with the production of goods.

This is also sometimes referred to as cost of sales.

Your ratio can also be calculated by dividing sales by inventory.

Other important measures to consider include:

Days of Sales Inventory (DSI): the measure of how many days it takes for inventory to convert to sales.

Also known as days inventory or days sales, this is calculated by taking the inverse of inventory turnover ratio and multiplying it by 365 to put the figure into daily context. It looks like this:

(Average Inventory / Cost of Goods Sold) x 365

You want this number to be as low as possible as it translates to a shorter amount of time required to turn your inventory into cash.

Because this number can vary between industries, you must compare DSI to companies in your industry to get an idea of how you’re performing. If you’re in the grocery industry, you’ll obviously always have a lower DSI than if you were in

the automobile industry.

Example:

Looking at the Fiscal Year ending in January 2018, Walmart reported $500.34 billion annual sales. They reported $43.78 billion in ending inventory, and $373.40 billion in cost of goods sold.

This means Walmart's inventory is: $373.4 billion / $43.78 billion = 8.53

The days total: (1/8.53) x 365 = 42 days

This means Walmart sells its entire inventory within a 42-day time frame, which considering their size, is quite impressive.

Though smaller companies may take longer, the good news is they can often afford to hold on to less inventory at a time, allowing them to keep control of costs while still meeting customer demand.

Your inventory ratio is a number you need to keep a close eye on because it is such an effective measure of how well your company is converting its inventory to sales.

Not only this, but it also provides insight into how well costs are managed when it comes to inventory, as it can help you see whether they are purchasing too much inventory or not buying enough.

Inventory turnover ratio also indicates how well your organization sells its goods. If sales are down, or the economy isn't doing well, it may show in your inventory turnover ratio.

Generally, your organization wants a higher ratio because it indicates you're making more sales.

If the ratio is too high, however, this may mean you're losing sales because there just isn't enough inventory available to meet demand.

Use industry benchmarks to determine if your company's inventory turnover ratio is where it should be so you can ensure you're managing your inventory properly.

Regular ratio analysis is critical, because if you find that you have too much

money tied up in excess inventory, you could find yourself running into cash flow issues.

If you consistently find that you have a low turnover, you risk products in your inventory reaching obsolescence so you'll have a much harder time selling to earn a return on your investment.

PLANERGY makes it easier to keep an eye on your inventory management. Not only can you more easily manage your suppliers, but you can manage your inventory directly within the platform.

This helps reduce holding costs because employees can order goods you have in storage, rather than placing an order with a supplier, leading to excess inventory.

With real-time visibility, everyone on your team can see what's in inventory as it stands at the moment. This helps reduce spending and prevents having too much stock on hand.

To ensure optimal growth and longevity, it's crucial to know how much your company sells at any given moment in time.

Keeping track of various financial ratios is one of the best ways to get a snapshot of what's going well and what needs improvement.

Without an effective system that streamlines workflow while also keeping track of the vital data you need for analysis, you risk stifling company growth, or worse, causing the company to fail completely.

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