The Inventory Turnover Ratio – Your Key to Boosting Manufacturing Efficiency

by Darren Kerr

If you run an inventory-based business, it's critical that you have systems and processes in place to manage your inventory effectively. Having too much or too little stock will put a drag on your bottom line and hurt your cash flow. How can you make sure you're effectively managing your inventory? There's actually one simple ratio that can help you evaluate the health of your inventory management—the inventory turnover ratio.

Understanding the Inventory Turnover Ratio

Determining your inventory turnover ratio will help you identify your business' sweet spot in inventory management. The ratio is calculated in one of two ways:

- Inventory Turnover = Cost of Goods Sold / Average Inventory*

or

- Inventory Turnover = Sales / Inventory

*Average inventory can be calculated as (Beginning Inventory + Ending Inventory) / 2.

Both calculations are used frequently. However, the second is a less accurate representation of how long your inventory is truly on hand, since it includes the markup.

What Does the Ratio Signify?

As a general rule of thumb, a higher ratio indicates more efficient inventory management (i.e., keeping less inventory in stock). This generally implies that you are paying lower storage fees and have fewer dollars tied up in your stock, which, in turn, could free up cash for investing or reducing borrowing needs. A higher inventory ratio also indicates that your risk of obsolescence is lower, which is especially important for technology, fashion or other goods that are either improved upon or lose consumer appeal quickly. Understanding your inventory turnover will also enable you to maintain tighter control on your supply chain, helping you inch closer to a "just-in-time" inventory system.

That said, be wary of turnover ratios that are too high; this indicates that very little inventory is on hand. If you receive a large, sudden order, you may have to incur additional costs to fulfill the order—or, you may not be able to fill it at all.

Using Inventory Turnover Ratio as a Comparability Tool

Using industry data to benchmark your inventory turnover ratio is a great way to understand what's normal for your business. However, your business is unique and, in turn, your most efficient ratio will be unique. Calculate your inventory turnover ratio each month to creäte a trend analysis for budgeting and forecasting needs. The more history you have, the better you're able to understand what's normal for your business.

How Can You Improve Your Inventory Turnover Ratio?

Now that you know just how valuable a tool the inventory turnover ratio can be, you might be wondering how you can improve yours. There are a multitude of ways, but here are some practical strategies:

- Order smaller quantities from suppliers more frequently
- Forecast your sales demands and order only what you expect to sell to meet expectations
- Reduce lead time from vendors and suppliers
- Use automated systems to track inventory and sales demands
- Research more affordable distributors

- Create a marketing campaign to increase sales
- Eliminate old inventory and focus on top selling products

Do you have questions about inventory turnover ratios, or other accounting issues? Please contact Darren Kerr at 330-668-1100 or email Darren.