

How to More Effectively Convert Your Inventory into Cash

By
Terry H. Hill

1

Converting your inventory into cash is as critical a process for the health of your company's cash flow, as the process of converting Accounts Receivable into cash. The effective conversion of inventory into cash requires a methodical system that efficiently moves products from order to delivery. Without a well-defined inventory management system in place, inventory stock levels may become too low or too high, resulting in lost sales and increased costs. The longer an item(s) remains as inventory, the greater the chance for the item(s) to become either damaged or obsolete and this eventually results in an inventory write-down. Slow-moving inventory adds to a slower cash flow and consequently creates greater carrying costs that must finance the inventory. The degree of success, in converting inventory into cash, is directly related to the how well the inventory cycle is monitored and controlled.

The inventory cycle, from order to delivery, involves the flow of both information and material. Information is initially generated from your sales forecast. As the inventory cycle advances, information is generated from the receipt of sales orders and the placement of purchase orders to your suppliers. Material flow is the movement of raw materials into your company that are processed into finished goods. The material flow cycle ends with the movement of finished goods to your end-user.

If you are a manufacturer, your inventory consists of three basic types of inventories: raw materials, work in progress, and finished inventory. Each of these types represents the various stages of completion of your product as it works its way through the manufacturing and assembly processes. If you are a retailer or wholesaler, you deal only with finished goods inventory.

Ratio Analysis:

The periodic use of ratio analysis to monitor the performance of your inventory is a highly recommended practice. The two main ratios for evaluating how well you manage your inventory are the Inventory Turnover Ratio and the Average Number of Days of Inventory:

- **Inventory Turnover Ratio (ITR):** The ITR measures the number of times your business "turns over" its inventory in a year. It is a measure of the operating efficiency of your business. The more frequent the inventory turnover, the greater the ratio. A higher ratio is preferable. To calculate inventory turnover, divide Cost of Goods Sold (COGS) by Average Inventory. Use only finished inventory to simplify the calculation. A low turnover rate may point to overstocking, obsolescence, or deficiencies in the product line or marketing effort. However, in some instances, a low rate may be appropriate; that is, when higher inventory levels have occurred in anticipation of rapidly rising prices or shortages. A high turnover rate may indicate inadequate inventory levels, which may lead to a loss in business.
- **Average Number of Days of Inventory (ANDI):** ANDI measures the number of days it takes, on average, to sell your finished goods inventory. This ratio is simply the inverse of the Inventory Turnover Ratio. To calculate the ANDI, divide the number of days in a year (365) by the ITR. The fewer the number of days that finished goods sit on the shelves, the better.

Monitoring your Inventory Turnover Ratio and Average Number of Days of Inventory helps you to improve inventory management and to avert write-offs associated with stale inventory.

How to More Effectively Convert Your Inventory into Cash

By
Terry H. Hill

2

Sales Forecasting Process:

Believe it or not, most small businesses do not invest the time in forecasting future sales--- even though cash flow projections demand it! Accurate forecasting of future sales not only impacts your cash flow projections, but it also becomes the foundation for establishing adequate and realistic inventory levels. Without a solid projection of future sales, managing your company's inventory and cash flow would be difficult at best. Sales forecasting is a critical activity for reducing risk and avoiding the high costs of either under-stocking or over-stocking of material.

Sales forecast are not without its set of problems. If sales forecasts are projected too optimistically, then cash is often tied up in slow-moving inventory and profit margins are reduced due to wasted overhead. On the other hand, if sales forecasts are projected too pessimistically, then the result is poor delivery performance, dissatisfied customers and revenue shortfalls due to limited product availability. The benefits of sales forecasting far out way any of its pitfalls: increased revenue, increased customer retention, increased operational efficiency, and overall decreased costs.

Since your company's sales forecast is based on previous sales, it is necessary to obtain accurate totals of dollar sales and unit volume for the past several years. Your sales forecast should include, both internal and external elements, since both can affect future sales. Internal elements include the use of accounting records, financial statements, and sales/customer service reports that will be scrutinized and analyzed in the preparation of your sales forecast. External elements include data on market conditions, economic climate, and competitive influences. The forecast's internal and external data should be collected and analyzed on a consistent basis.

Procurement Management Process:

A company's use of best practice purchasing methods in order to optimize price savings, to insure quality products and to develop strong vendor relationships cannot be overstated. Unfortunately, many purchasing decisions in small businesses are not based on best practices. Wise purchasing decisions should not be made solely on volume discounts which generally produce lower unit prices. Under certain circumstances, this volume discount approach has its benefits. However, one should not be lured by the myth that this approach works optimally all of the time! In fact, this volume discount approach can be a major contributor to elevated inventory levels.

A more pertinent approach to purchasing is the Economic Order Quantity (EOQ) method. The EOQ is an inventory model that indicates the quantity to be ordered which reflects customer demand and minimizes total ordering and holding costs. EOQ inventory model employs the use of sales forecasts, historical customer sales volume reports, and the ongoing monitoring of current customers' sales activity.

The Procurement Management Process involves the following steps:

- 1) **Review Open Sales Report and Inventory Min/Max Report:** Periodic analysis of these reports is mandatory in order to determine the quantity that should be ordered to replenish standard in-stock product inventory levels or non-stock items.

How to More Effectively Convert Your Inventory into Cash

By
Terry H. Hill

- 2) **Issue Purchase Orders:** A formal purchase order (PO) must be issued to each supplier. The PO should include pertinent information: product description, quantity, quoted price, and time frame for delivery.
- 3) **Purchase Order Procedures:** Procedures that are recommended:
 - (a) **Receive/Review Items:** Once the items have been received, inspect them to determine whether or not they meet the description and quantity as stated in the Purchase Order and to determine any existing damages.
 - (b) **Resolve Issues:** Any discrepancies between "what was ordered" and "what was received" or any product damages must be noted on the shipping documents and the supplier must be immediately notified.
 - (c) **Accept Items:** After resolving any delivery, damages, or discrepancy issues, the Shipping/Receiving Supervisor accepts the items on behalf of the company.
 - (d) **Approve Payment:** After the supplier issues an invoice for payment, the invoice must be approved before scheduling and issuing payment.

3

Following above three steps ensures better supplier relationships which, in turn, create greater customer satisfaction.

Inventory Control System:

Inventory control is difficult to embrace. Inventory control is a system of maintaining inventories in order to prevent stock outage, to control overage and shortage, to reduce carrying charges (interest, storage, and insurance), and fend off theft. Documenting policies and procedures that provide the guidelines for effective and efficient inventory control is a must.

Examples of Inventory Control requirements are:

- **Inventory accuracy:** Inventory records must be consistently accurate in order to control costs and to fulfill sales order requirements.
- **Reduce internal lead times:** Overall lead time of raw material, sub-assemblies, and finished goods must be reviewed in order to discover if any inefficiency exists.
- **Speed up the time to replenish raw material:** Replenishing raw materials in a timely manner, so that adequate inventory levels can meet customer demand, is critical. Knowing suppliers' lead times is the key to accurately replenishing raw materials.
- **Review order quantities:** As mention earlier, ordering large quantities, in order to get a "volume discount," is not always the best method for reducing cost. The Economic Order Quantity (EOQ) method of purchasing works well in lowering overall cost.

How to More Effectively Convert Your Inventory into Cash

By
Terry H. Hill

- **Clean out old inventory:** Identifying obsolete or slow moving inventory items, and then, developing channels in which to sell and/or dispose of those items, not only frees up storage space, but also generates immediate cash.
- **Hold your suppliers accountable:** Holding suppliers accountable for on-time deliveries, as well as, for consistent quality control of their product is important. Late deliveries can mean loss of sales due to inadequate inventory levels. Products of poor quality increases product returns from customers, and if done repeatedly, could ultimately result in loss of sales.
- **Inventory Reports:** Creating a Min/Max Inventory Report, which defines the minimum and maximum inventory count levels for each line item that is in stock, is imperative. The difference in count, between the minimum and maximum level, will vary from product to product since it is based on a projected daily sales volume for that product. Lead time from the supplier also plays an important role in determining min/max levels.

4

Following a pre-established set of processes and procedures - as defined above – helps to more consistently shorten the inventory cycle time. By shortening the inventory cycle time, the process of converting your inventory into cash becomes more efficient and effective. Improving the rate, at which inventory is converted into cash, ultimately generates a healthier cash flow.

To download a copy of this article, click on this link: http://www.legacvai.com/Convert_Inventory.html

Copyright © 2008 Terry H. Hill

You may reprint this article free of charge in your newsletter, magazine, or on your website, provided that the article is unedited, and that the copyright, author's bio, and contact information below appears with each article. Articles appearing on the web must provide a hyperlink to the author's web site, <http://www.legacvai.com>

Copyright 2007-2008 Terry H. Hill:

Terry H. Hill is the founder and managing partner of Legacy Associates, Inc, a business consulting and advisory services firm. A veteran chief executive, Terry works directly with business owners of privately held companies on the issues and challenges that they face in each stage of their business life cycle. To find out how he can help you take your business to the next level, visit his site at <http://www.legacvai.com>