

INVENTORY TURN OVER RATIO

The Inventory Turn Over Ratio shows how fast a company sells its products. It helps the business see if it's managing its stock well and turning it into cash.

If certain products remain unsold, the company can sell them at lower prices to clear them and free up capital. It gives insight into:

- Assess the company's efficiency and competitiveness
 - Identify areas to improve purchasing and inventory practices
 - How well cash is being turned over through sales
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- A high ratio means strong sales or low inventory levels.
 - A low ratio means weak sales or too much stock.

1. How do you calculate the Inventory Turn Over ratio?

To calculate the Inventory Turnover ratio, a company divides the Cost of Goods Sold (COGS) by its average inventory:

The formula is as follows:

$$\text{Inventory Turn Over ratio} = \frac{\text{Costs of Goods (Sold)}}{\text{Average Inventory}}$$

COGS: Includes all direct costs needed to produce the goods (like material and labor).

Average Inventory: It is usually calculated as

$$\text{Average Inventory} = \frac{\text{Inventory at the start of the period} + \text{Inventory at the end of the period}}{2}$$

EXAMPLE

Suppose a company had::

- Opening Inventory: 50.000€
- Closing Inventory: 90.000€
- Cost of Goods (COGS) for the year: 420.000€

Step 1: Calculate Average Inventory

$$\text{Average Inventory} = \frac{\text{Inventory at the start of the period} + \text{Inventory at the end of the period}}{2} = \frac{50.000\text{€} + 90.000\text{€}}{2} = \frac{140.000\text{€}}{2} = 70.000\text{€}$$

Step 2: Calculate Inventory Turn Over ratio

$$\text{Inventory Turn Over ratio} = \frac{\text{Costs of Goods(Sold)}}{\text{Average Inventory}} = \frac{420.000\text{€}}{70.000\text{€}} = 6$$

So, the company turned over its inventory 6 times during the year. This means it sold and replaced its inventory six times, which may indicate stable sales and efficient management, depending on the industry.

2. How many days does it take to clear inventory?

After calculating the inventory turnover ratio, a business can estimate how long it takes to sell its inventory using the Days of Inventory (DSI) formula:

Example

If the turnover ratio is 6 and the time is 365 days:

$$DSI = \frac{365}{6} = 61 \text{ days}$$

This means that the company needs about 61 days to sell in stock.

Tracking DSI helps companies manage inventory better, reduce holding costs and improve cash flow.

3. What to adjust when Turnover is low?

If the turnover ratio is lower than expected, the company can review the following aspects:

- Marketing: Are customers interested in what's offered? Is the classification of the products, correct? Should promotions be increased?
- Pricing: Are the prices too high? Should the company offer discounts or product bundles?
- Sales: Are sales teams performing well? Do they need tools or training?
- Supply Chain: Are delays or shortages affecting stock availability?
- Operations: Are production or delivery times causing inventory to pile up? Should purchases be reduced?

4. How to find the Right Turnover Benchmark?

It's important for a business to compare its inventory turnover ratio with others in the same industry. For example, electronics like laptops usually sell faster than high-end items like luxury cars, so turnover expectations differ.

Industry benchmarks can be found online or through trade associations and market research reports. Past company performance can also serve as a useful reference point.

5. How Turnover reflects your business performance?

The turnover ratio alone doesn't explain everything.

A low turnover ratio might happen for many reasons such as:

- Buying extra stock to prepare for future demand.
- Delays or problems with suppliers.
- Lower customer demand than expected
- Higher prices that slow down sales.

While a high turnover is usually a good sign, a low one isn't always bad. It depends on the situation:

Still, slow turnover can lead to:

- Higher storage and holding costs
- Cash being stuck in unsold products
- Needing to offer discounts to clear stock

That's why it's important to look at turnover along with other business factors before making decisions.

6. What's considered a "Good" Turnover ratio?

A high turnover ratio is usually a good sign. It means products are selling well and inventory isn't sitting unused. This also indicates that the company maintains lower levels of capital invested in unsold inventory, thereby enhancing its cash flow position.

So, a "Good" index depends on the industry, the business model and specific goals.

7. Include the inventory turnover indicator in your regular monitoring process to get a clear picture of the efficiency of your product management

Inventory turnover is a key indicator that shows how quickly a business is selling its inventory. It helps owners understand how effectively they are managing inventory and how the business is performing.

However, many small businesses, especially those with limited time and resources, do not regularly monitor this indicator as a result, they may miss early warning signs, hold excess inventory or miss opportunities to improve cash flow.

Adding inventory turnover to the regular monitoring process of this indicator reflects how well inventory and sales are aligned for better decision making.