



# Inventory...A Necessary Evil for the Small Business

Most small businesses require inventory to operate. Retail stores need products on their shelves, distributors need goods to sell to retailers, manufacturers need materials to produce their products, and even most service companies require some form of inventory such as spare parts in order to make repairs or maintain equipment. The availability of inventory, and the ability to sell it at a profit, is part of the formula for growth. But conversely, having not enough of the right inventory and too much of the wrong inventory, is the recipe for disaster.

So what's "right" and what's "wrong" when we speak of inventory? "Right" inventory is inventory that moves through your operation quickly. It's inventory that "turns over" fast meaning that from the time you buy it (convert cash into inventory) until the time you sell it (convert inventory back in to cash), is a reasonable amount of time that allows you to maintain adequate cash flow. Your money isn't always tied up in inventory and spends more time in the bank than on a shelf.

The amount of "right" time depends greatly on your type of business. If you are a retail operation that time should probably be counted in days. If you are a manufacturing operation, that time is probably counted in weeks and in some cases even months. A service company may also hold their inventory for months because they have to hold such a wide variety of parts.

Unfortunately, there is no magic formula other than to hold no more inventory



than you have to in order to operate your business so that you are profitable and have the cash to fund growth.

So where does the "evil" side of inventory come in? Inventory becomes evil when you can't convert it back into cash fast enough or at all. It becomes evil when it sits on the shelf of the retail store for days or weeks on end, or in the warehouse of the manufacturing plant for months and

months. All the time you have to keep buying the inventory that IS selling, but you have cash tied up in inventory that isn't selling. Companies can show a profit on their income statement but without cash in the bank, they can go out of business. They can't pay their bills or make payroll, vendors start to demand payment and cancel credit terms, banks call loans...it can get real ugly real fast. It's imperative that small companies conserve cash and avoid committing too much of it to inventory. Here are a few simple rules to remember when it comes to managing your inventory.

### **1. Know what you have and where it**

**is.** It sounds simple but so many small companies don't count their inventory often enough or at all. You don't know what you don't know and you can't possibly make sound decisions about what inventory to buy, how much to buy, and when to bring it in, unless you know how much you have. While you're at it, find it...know where it is. Again this sounds simple, but all too often companies "know" they have inventory, but they can't find it. Then what? They buy more. Small businesses don't count their inventory because it's an arduous task that takes time and labor and often means shutting down the operation or doing it after hours, both an inconvenience. Find a way to get it done. Turn to technology and invest in a barcode system and cut the time from days to hours. Consider "cycle counting" your product. Instead of counting all 1,000 SKUs, count 100 a day very day over the course of two weeks (10 business days) or come up with your own cycle schedule. Do whatever you have to do to put a program in place where you count your inventory regularly, at least quarterly if not monthly depending on your business.

### **2. Know what you're selling or producing and at what rate.**

Again this sounds

obvious but a lot of small businesses look at the numbers at a high level (revenue) and order more inventory when they run out of what they had, or buy when their supplier offers them a good deal. Look at the rate of sale (retail) or consumption (manufacturing) of each item and know how many you need each week or month or quarter, and use this information when you're making purchase decisions on future inventory. Your sales data should give you this information from either your Point-of Sale system for retail stores or your accounting system for manufacturing companies. If you're a manufacturing company and your accounting software isn't that sophisticated, research what's called a "Kan-Ban" system. It's a simple card system that triggers a purchase when your inventory of a part gets down to a minimum level....no computer required for the most basic implementation.

### **3. Bring in new inventory in smaller increments more frequently.**

Let's say you know you need 1,000 widgets each month and your supplier will give you 30 day terms when you buy them. You bring in the 1,000 you need, but just know that in 30 days you have a big bill to pay. Why not bring in 250 each week? Doing so cuts that big invoice into four smaller, more manageable bills spread out over a month. You hang on to your money longer, smoothing out your cash flow. Worried the supplier may not go for it? Worried they might not give you the same price? You never know until you ask. Negotiate. Most suppliers will work with you if they want your business and if they won't, consider suppliers that will. Look for every way possible way to conserve your cash and spread out your bill payments.

### **4. Avoid FISH inventory at all costs.**

FISH stands for "First In, Still Here". Use your data that tells you how much inventory you have and how much you're

selling, or consuming, to make rational decisions about how much inventory to buy and when to bring it in. If an item is selling like hotcakes and all the indications are that it will continue that trend, then bring in a little more. Make the investment and if it continues to sell, your company will grow. But if the sale or consumption of an item is slowing, or worse stopped, it doesn't take a rocket scientist to know not to buy any more of that item. And never let a supplier influence or even make purchasing decisions for you. It's their job to SELL you, not to protect your bank account. FISH inventory is the most sinister of the evil inventory because it will either have to be sold at deep discount which means little or no profit, possibly even a loss, OR it will have to be written off entirely and discarded, which means a 100% loss on the cash invested in that inventory. You might as well have thrown the money in the trash can to start with. Doesn't get much worse than that.

**5. Consider marking your inventory** with some sort of date or lot code so that you use the oldest inventory first. You can even just store the inventory in a manner so that the oldest inventory is sold or pulled first. The same approach is used at the grocery store in the dairy aisle. Milk is stocked on the shelf with the oldest in front so it gets pulled first. Use a similar strategy to ensure that you don't get stuck with inventory that has become obsolete, outdated, or maybe even ruined.

**6. Minimize your inventory losses.** Losses are called "shrinkage". Let's say you start with \$1,000 in inventory and you sell \$200 of it, but when you count it again you only have \$700. What happened to the other \$100? No one knows? That's shrinkage. Its unexplained inventory losses. It might be theft, either by customers or employees. It might be spoilage or inventory that as ruined

during the manufacturing process and not accounted for. Or it could be just bad bookkeeping. Maybe you really sold \$300 in inventory, not \$200, but your system for valuating your inventory has a problem. Maybe you really didn't lose the \$100 but it will show up as a loss on your financial statements. How can you prevent or minimize shrinkage?

- ▶ The first step in preventing inventory shrinkage is to go back and read tip #1. Count your inventory and count it often. Discrepancies will occur in your accounts between physical counts and the sooner you discover there is a problem, the easier it will be to find the source. The more time that lapses, the harder it will be to find the cause of the shrinkage. It's just common sense.
- ▶ Store your inventory properly. Remember what your inventory is... its cash that has temporarily taken the form of products that you will sell. It has value but only if you take care of it. Store it properly. Handle it with care. Invest in proper containers, shelving, racks, and product-handling equipment...whatever will allow you to move and store your inventory in the safest way possible. Break it or ruin it and its garbage. Money down the drain.
- ▶ If you are a manufacturing company, always scrutinize your Bills of Materials, which are the parts lists from which your products are made. The valuation of your products is based on these "BOMs". If the BOMs are wrong, your inventory valuation will be wrong. If you are using parts in the assembly of your product that are NOT listed in your BOM, then they aren't "relieved" from inventory and your accounting system thinks they are still on the shelf in their bin. But when you go to count, they aren't there. You just experienced inventory shrinkage.

- ▶ Train and educate your employees. Help them to understand that inventory is a company asset just as much as cash is. How they treat inventory impacts the company's bottom line which also impacts the company's ability to offer competitive salaries and benefits. Encourage them to take ownership and respect inventory for what it is.

While inventory is indeed a "necessary evil", when managed properly it is the catalyst for profitability and growth. Treat it with care and you will be rewarded.



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