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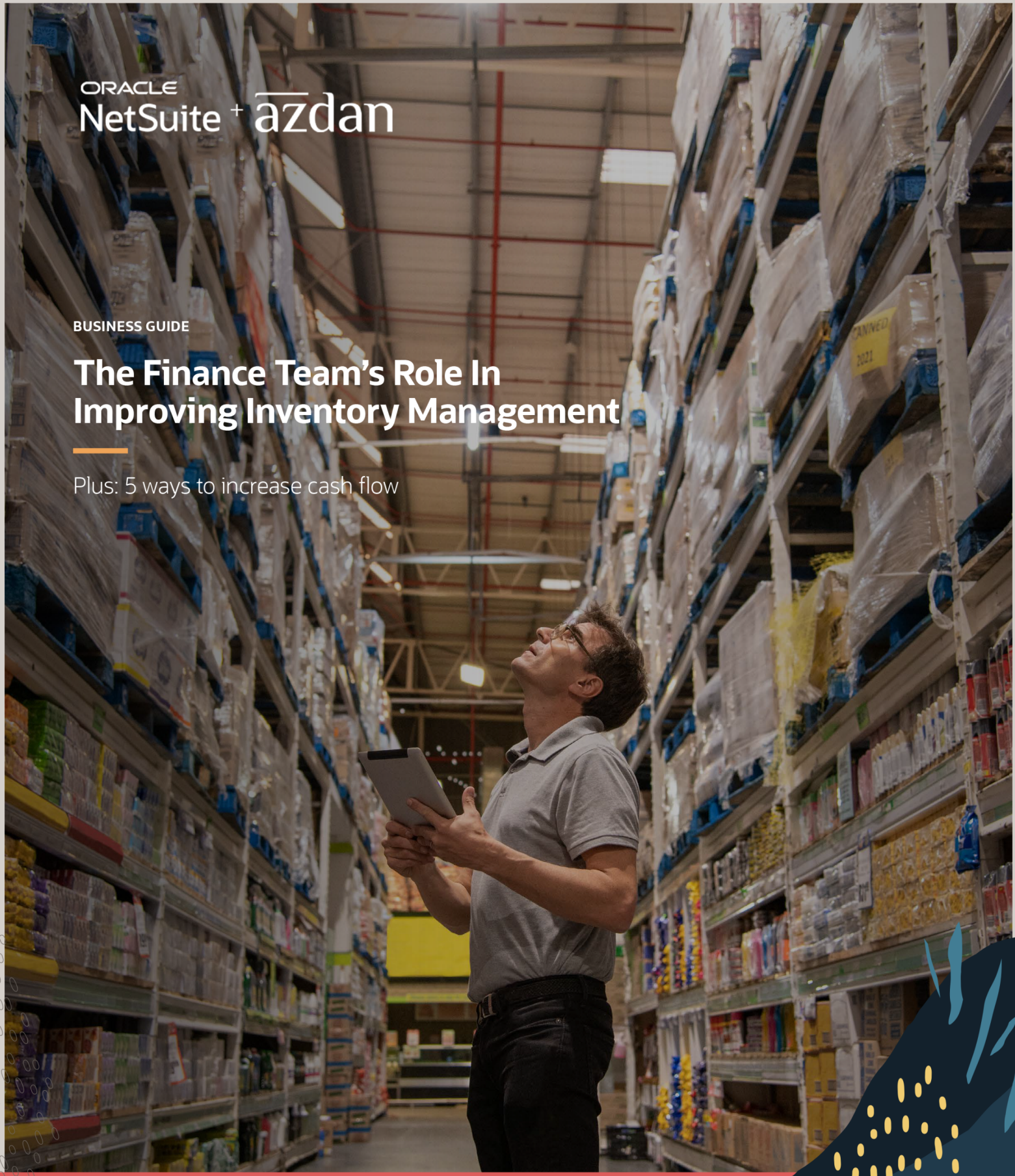

BUSINESS GUIDE

The Finance Team's Role In Improving Inventory Management

Plus: 5 ways to increase cash flow

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Read Time: 10 minutes

The Finance Team's Role In Improving Inventory Management

Plus: 5 ways to increase cash flow

The increasing threat of recession has executives and investors going back to basics. Growth at all costs is out. Cash flow, profitability, and other fundamental indicators of financial health are now the focus for CFOs across industries.

These metrics have always been important, of course. But they're not always the driving factor behind business leaders' decisions or monitored by executives at a granular level. Now, as CFOs look to unearth hidden costs and push investment toward proven profit makers, they must dig into the details. For products companies, that means understanding the nuances around inventory management. Not only is inventory both one of the largest expenses and the primary generator of revenue, as a current asset, stock also shows up on the balance sheet and represents a large portion of working capital.

Simply knowing the total amount of money tied up in inventory is no longer sufficient. CFOs must play an active, hands-on role in patching profit leaks and eliminating unnecessary expenses related to buying, holding, and selling these items. It's not a job that can be left solely to operational leaders.

In this guide, we'll walk through five steps CFOs can take to improve inventory management in a way that will directly boost cash flow. For each, we'll provide two or three metrics companies can use to monitor their efforts in each area.

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CHAPTER 1

Rationalize Your SKUs

When every dollar counts, it makes sense to concentrate time and resources on the services or products with the best mix of high profit margin and healthy sales volume. That means reducing the money spent on low performers, whether by scaling them back or removing them from your product catalog entirely. A simple ABC analysis based on these two factors is a good place to start. Realize that your list of top performers can change quickly — the rising costs of storage, labor, and transportation have all had a lasting impact on margins.

To understand which items contribute most to your bottom line, you need to track sales trends. You also need to reliably track margins on all the goods you sell and understand how they've changed over the last quarter or year. While this is the core criteria, other factors that merit consideration include where these items are in the product life cycle, the difficulty of acquiring the material inputs and labor required to produce them, and their customer base. Analysis requires current and historical data on purchases, inventory items, and orders. Outdated numbers could lead you to push ahead or pull back on the wrong products.

Based on data, you can order more top profit-makers or, if you're a manufacturer, reallocate human and machine capacity. You can also develop a more strategic plan for marketing and the sales team. That could include setting promotion and discount restrictions by product to prevent margin erosion.

It's critical that CFOs be involved here because they're attuned to the bottom line, while the sales organization is typically driven by the top line. Hitting quotas, however, does little for cash flow if customers are buying up products with razor-thin margins.

Metrics to watch

Contribution margin percent: Unlike gross profit margin, contribution margin accounts only for variable costs and does not include fixed costs. For a more accurate picture of your contribution margin, deduct returns from product revenue.

Contribution margin percent =
Product sales revenue – Product variable costs /
Product average selling price x 100

Cost per unit: To understand your margins and top performers, you need an accurate picture of all the costs that go into a given product. This includes everything from rent to customer acquisition to shipping.

Cost per unit =
(Total fixed costs + Total variable costs) /
Total units produced

Be Aware of Relationships Among Different Products

SKU rationalization comes with many caveats because so many of the products you sell are interrelated. For example, watch out for lower-margin items that are often sold in conjunction with popular, high-margin goods. Say power tools are a mainstay of your product catalog and one of your highest-performing categories. Related maintenance items like lubricants and replacement parts are not as profitable, but it's a bad idea to stop selling them — you could ultimately lose business because buyers can place a single order for the tool and complementary items elsewhere. Before phasing out any SKU, evaluate its impact on related products.

CHAPTER 2

Fine-Tune Demand Forecasts

Many inventory problems can be traced back to a common issue: inaccurate demand forecasts.

Forecasts that exceed actuals lead to buying too much inventory, reducing cash on hand in two ways: By unnecessarily driving up inventory carrying costs and increasing the number of items that are eventually eventually written down or written off.

Similarly, a forecast that underestimates demand results in stockouts and lost revenue, also reducing cash on hand.

But the impact of inaccuracy extends beyond obsolete inventory and high stockout rates. Expected demand shapes staffing levels, manufacturing schedules, transportation plans, warehousing, and more. Each of those components is a major expense, which can make a miss that much more costly.

Accurate forecasts require the right data, including historical sales and forward-looking projections that may factor in external information. Much of that data originates from back-end systems that track inventory, sales, and related metrics, meaning those systems must be reliable, comprehensive, and able to record information over time. This makes forecasting a difficult science, one that can benefit from the CFO's financial and macroeconomic knowledge.

Leaders should insist that forecasts are both detailed and specific.

Broad numbers about the total amount of product needed for a quarter won't cut it. Heading into the holiday season, 27% of retailers reported they had enough total inventory but not in the right products, according to a Digital Commerce 360 survey. That's why projections should be broken down by item, channel, and location to include stores, warehouses, and third-party fulfillment centers. They also must be updated frequently, because conditions that affect demand can change very quickly during times of uncertainty.

Metrics to watch

Obsolete inventory percentage: This reveals what portion of your current inventory is no longer sellable or usable. As much as 20% of the goods many companies hold are obsolete; you should aim for a much lower number.

Obsolete inventory percentage =
Value of obsolete items / Total value of inventory x 100

Mean absolute percentage error (MAPE): Sudden changes in forecast accuracy at the product category or SKU level can indicate shifts in demand, and MAPE helps you spot them. Any forecast that's off by 15% or more signals a problem.

MAPE = [Sum of (Actual sales – Forecasted sales for period / Actual sales x 100)] / Total number of forecast errors

CHAPTER 3

Optimize Inventory Levels by Location

Purchasing the right amount of inventory based on an accurate forecast is just one piece of the puzzle. You must also have the right items in the right place at the right time — but in that same Digital Commerce 360 survey, 36% of retailers said managing inventory levels was one of their top challenges.

Although inventory comprises much of a product company's current assets, in many cases its value declines quickly if you can't move it efficiently. For instance, are the majority of items in an East Coast warehouse when 75% of demand is coming from California? Does product arrive two weeks after the seasonal rush? If so, expect substantial inventory waste and/or increased shipping costs.

Another piece of inventory optimization that's often overlooked but no less important is safety stock, the inventory a business carries to cover demand beyond what it anticipated. Striking the right balance comes down to keeping a close eye on safety stock levels and updating the required amounts for different products regularly. Too often, safety stock targets are outdated and no longer reflect the current reality of unpredictable supply chains or shifts in demand.

The same can be said for reorder points. Properly timing replenishment orders is no small feat, but regularly reviewing and updating the reorder point for various SKUs can ensure new products show up just as you're tapping into that safety stock but not so soon that they unnecessarily tie up cash.

The edict from CFOs should be that the company must justify all the inventory it's holding or has on order. Any waste is draining the pool of money that could be better spent elsewhere.

Metrics to watch

Safety stock: Lead time and daily usage can change quickly, so make sure safety stock calculations are based on the latest data.

Safety stock = (Maximum daily usage × Maximum lead time) − (Average daily usage × Average lead time)

Inventory aging: The average age of on-hand products can tell you if your carrying costs are higher than they need to be. It also calls attention to items or categories that need closer inspection.

Inventory age =
(Average inventory cost / COGS) x 365

Stock to sales ratio: This number shows whether you're over- or under-stocked by measuring inventory investment per dollar of net sales, accounting for returns. While lower is better, too low could suggest you're often out of stock.

Stock to sales ratio =
Average stock value / Net sales value

CHAPTER 4

Validate Your Inventory Data

Another common source of inventory waste is when the numbers in your system don't match on-hand quantities. People across your organization make decisions based on that information, so discrepancies cause problems. You may order less or more of various products than what's actually needed, for example, or make promises to customers that you can't fulfill.

Cycle counting can go a long way toward improving the accuracy of inventory data.

These frequent counts of select items are far less time-consuming and disruptive than full inventory counts, but over time you can cover a wide range of products in your warehouse. Think of cycle counting as a checks and balances on your inventory records. It can also uncover any increases in shrinkage, whether due to theft, vendor fraud, damage, or errors.

Given that finance chiefs usually oversee finance and accounting, inventory costing is another area to investigate. While there are several inventory costing methods, most companies choose first in, first out (FIFO) or weighted average cost (WAC), two GAAP-approved methods that make the most sense for most businesses.

The key is to be consistent with whatever method you choose, because your costing method affects COGS and therefore gross profit on your income statement. It also impacts remaining inventory value on your balance sheet. So accounting for inventory properly and consistently ultimately impacts your financial position and must be based on accurate data for units and unit cost.

Metrics to watch

Inventory accuracy: Measuring inventory accuracy requires counting your stock. Modern systems and scanners have greatly improved accuracy, so you should target at least 95%.

Inventory accuracy rate = (Actual inventory units / Inventory units on record) x 100

Shrinkage rate: When the difference between what's recorded and what you actually have is growing, shrinkage is often to blame.

Shrinkage rate = [(Inventory on record – Actual inventory) / Inventory on record] x 100

CHAPTER 5

Minimize Fulfillment Costs

Knowing the exact location of every piece of inventory in your possession has a major impact on costs and, consequently, cash flow, so CFOs must be confident that the operations team has precise and reliable information at their fingertips.

How does fulfillment impact your bottom line? Consider a company that has two warehouses, one in Phoenix and another in New Jersey. It stocks some products at both locations, so when a customer in Colorado places an order for a pair of headphones, it could ship from either location. The Phoenix location, however, is far closer, which means shipping costs may be lower if the item is sent from there. This is particularly important if this order surpassed the free shipping threshold.

To make these fulfillment decisions quickly, the business first needs visibility into available inventory across locations, a feature some entry-level inventory management systems lack.

But even if the company has multi-location inventory management, having an employee manually review each order to determine the best option based on location, promised delivery date, and shipping costs is time- and cost-intensive. A system that can automatically assess incoming orders and assign them to the ideal shipping location can pay for itself over time.

The potential to lift the bottom line with this kind of intelligent fulfillment is obvious. This is especially true given shipping costs, which soared during the pandemic and have climbed further, up more than 15% year-over-year, according to the Cass Transportation Index.

Shipping from a closer location can also get orders to customers faster, increasing loyalty and spend.

Metrics to watch

Shipping cost per order: This is a critical inventory metric for finance heads as shipping costs continue to climb. With the right strategy and technology, this number should fall.

Shipping cost per order = Total shipping costs for period / Total orders for period

Perfect order rate: There are many things that can go wrong between when a buyer completes a purchase and when it gets to them. This measures how often orders arrive with the right products, on time and undamaged.

Perfect order rate = [(Number of orders delivered on time / Total orders) x (Number of orders complete / Total orders) x (Number of orders damage-free / Total orders) x (Number of orders with accurate documentation / Total orders)] x 100

CHAPTER 6

Reducing Inventory Costs With Unified Financials and Inventory Management

CFOs don't have time to page through long inventory reports or crunch all these metrics themselves. With the automation a robust ERP system provides, leaders can quickly see their company's inventory position and how it's affecting financials.

NetSuite ERP offers financial management and inventory management in a single system with a common user interface, making it easy to understand and monitor the relationship between these two fundamental components of a business.

This starts with NetSuite's powerful reporting capabilities that help executives understand the performance of different SKUs over time, for example, so they can make adjustments to protect margins and boost cash flow. NetSuite can also provide real-time reports on inventory levels and performance to inform purchase orders and inventory transfers.

Additionally, NetSuite Inventory Management can dynamically calculate reorder points and appropriate safety stock levels based on historical and seasonal demand — all without your team lifting a finger. This, together with the ability to track stock down to the individual item across multiple locations, helps companies avoid over- or under-stocking. The system can support whatever costing method you choose and automate calculations to ensure financial statements are accurate.

This detailed inventory information then becomes the basis for demand forecasts that will land close to the mark. NetSuite offers forecasts of varying complexity to meet the needs of different businesses and a number of scenarios.

Your staff can also perform cycle and full inventory counts with NetSuite, which can trigger counts based on business rules you set up, like a bin that's fallen below the reorder point. Counts can happen while you're actively fulfilling orders.

Finally, NetSuite can automatically route orders to the ideal location based on proximity or cost, lowering shipping costs and times. That includes support for "ship from store" or "buy online, pick up in store," giving customers options while you save.

The Bottom Line

Every CFO's goal is to minimize the cash tied up in inventory without losing sales. To deliver on this goal, finance leaders must investigate current inventory practices and partner with that side of the business on targeted improvements. Because there's often ample room for inventory-related savings, that effort will help finance chiefs put their name on strong financial results in a time when many businesses are struggling or concerned about their near-term future.

These added responsibilities are part of the ever-increasing expanse of the CFO role. As finance leaders become more of an operator in the day-to-day of the business, inventory management is falling within their purview. Reining in what is such a large expense is a powerful way for CFOs to make their mark.

Learn More

- **33 Inventory Management KPIs and Metrics for 2022**
  Everything you need to know about inventory management KPIs and metrics plus expert advice and tips for success.
- **Retail Inventory Management: What It Is, Steps, Practices and Tips**
  Inventory management is a pillar of a successful retail operation. Here's how to satisfy customers, reduce costs, and increase profits.
- **ABC Analysis in Inventory Management: Benefits & Best Practices**
  ABC ranks items on demand, cost, and risk data so business leaders know which products or services are most critical to their financial success.

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