Your guide to inventory

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Learn the strategies and techniques behind successful inventory management. And be smarter in how you buy, count and value the lifeblood of your business.

1

What is inventory?

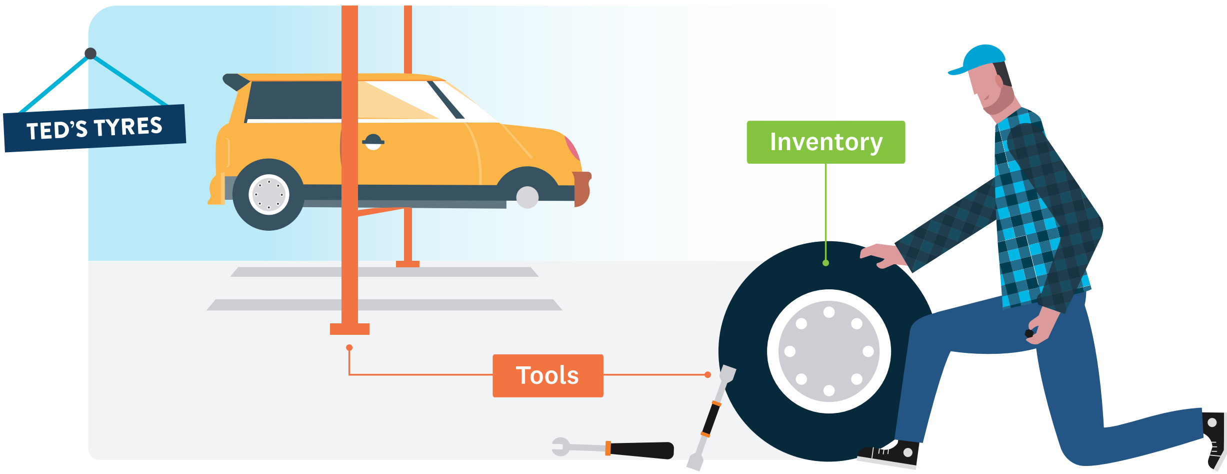
Of all the purchases you make as a business owner, your inventory is one of the most important. It's the reason you're in business.

What is inventory?

Inventory – or stock – is what your business buys in order to resell to customers. It may be changed in some way, or sold as it is.

For something to be inventory:

- **You must have bought it**
  If you're selling something on consignment, it still belongs to the manufacturer or supplier. That's not your inventory – it's theirs.
- **It must be for sale**
  Things that you've bought to help run your business – such as stationery or work tools – aren't inventory.



Only items that are kept by your customer are inventory. The tools you use along the way are not.

Why have inventory?

You could just order what you need, exactly when you need it. And some businesses are able to operate on a just-in-time system like this. But for most businesses, it's impossible to organise such a precise supply chain.

Having inventory on hand has a number of benefits. It lets you:

- be responsive to customer demand
- deal with seasonal or cyclical demand
- have some independence from suppliers
- take advantage of price discounts and bulk buying
- delay the impact of price increases
- reduce delivery costs
- avoid work stoppages between manufacturing stages
- manage products with long lead times

What should I do about inventory?

If your business has inventory – and most do – there are a few things you'll need to do:

- **Report it to the right people** – inventory contributes to the value of your business, so it must be reported on tax returns, business valuations and insurance policies.
- **Manage it smartly** – inventory can both make and lose money for your business, so you need to put some thought into how and when you order and store stock.
- **Keep on top of the numbers** – to correctly report and manage inventory, you need to understand the cost and value of it. That's where inventory accounting comes in.

This doesn't have to be as hard as it sounds. There are accounting tricks to make it easier on small businesses. As you grow, you can use software and apps to do a lot of the time-consuming jobs, and number crunching.

2

Types of inventory

Inventory comes in many shapes, forms and stages. Understanding the types will help you identify it for valuation and management. Let’s look at them.

Merchandise you’re reselling

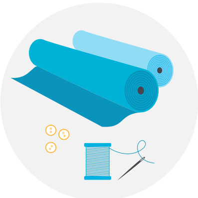
Most retailers have goods on the shelves, plus more out back. That’s all inventory.

Products you’re installing as part of a service

Many types of service businesses sell goods along with their labour. For example, a mechanic typically sells things like gaskets as part of a job. A gardener charges for the fertilisers they apply. A hairdresser may stock and sell hair products. Goods like these are inventory, too.

Goods you’re making (manufacturing)

Manufacturers deal with three types of inventory. They are raw materials (which are waiting to be worked on), work-in-progress (which are being worked on), and finished goods (which are ready for shipping).



Raw materials

Work-in-progress

Finished goods

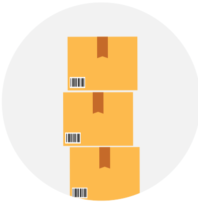
You can have many types of inventory

You might sell some products exactly as you bought them, while modifying others. In this instance, you have merchandise and raw materials. It’s easier than you think to overlook inventory. Thinking about the three types can help you identify it all.

Location of inventory

The inventory you own can be in one of four places:

On the shelf
It may be on display and ready for sale.



In storage
It may be out the back of a shop, in a warehouse, or in a work van.

In transit
It may be in a vehicle between supplier and buyer.

On consignment
In someone else’s shop, waiting to be sold (some retailers will only buy a product from a manufacturer or supplier after they’ve on-sold it).

Looking after inventory

Knowing what inventory you have, and where it is, will help make you a better business person. You’ll be more aware of where your money is tied up, and you’ll be able to make decisions that protect that investment. Your next step is to work on how you manage inventory.

3

Inventory management

Having a complete overview of your inventory will help your business run smoothly and profitably, so where do you start?

What is inventory management?

Managing inventory consists of:

- **keeping track of goods**
  where they are and how long you've had them
- **knowing their value**
  what they cost and how much they're selling for
- **forecasting demand**
  learning what sells and ordering accordingly

Why is inventory management important?

When you manage your inventory well, you can:

Improve cash flow $

You'll have less money tied up in slow-moving items.

Increase sales +

You'll be less likely to run out of stock.

Boost profits ↗

You'll learn which products deliver the best returns for your business.

One of the main aims of inventory management is to hold inventory for less time. This reduces stock handling, lowers losses due to damage or spoilage, and reduces the risk of products becoming obsolete.

You'll also find out which product lines are bringing in the most customers (highest sales), versus generating the most revenue, versus delivering the best margins. That's all good to know.

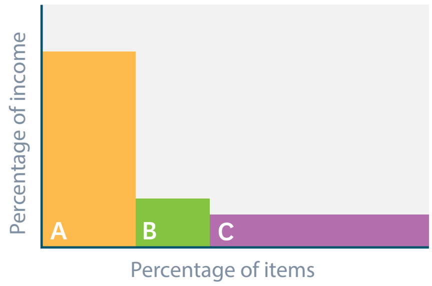
How to start optimising inventory

You can see the value of your inventory and you want to manage it smartly. So what do you do?

Inventory optimisation is a big topic, and it can involve a lot of maths, but you don't have to jump straight in the deep end. Here are three things you can do right now to get on the right track.

1. Begin with an ABC analysis

Financially speaking, not all inventory is equal. A small proportion of items often drive a lot of your sales and profits. This is often called the 80/20 rule. An ABC analysis involves sorting your inventory into three broad categories:



A. *The select few items that bring in most of your income*

B. *The OK performers that contribute a decent amount of income*

C. *The bulk of items that don't earn much (due to low sales and/or prices)*

Pay particular attention to your **A** inventory, because mistakes in that category can cost a lot of money. The **C** items require less of your attention. This exercise gives you a framework for prioritising your focus and energy.

2. Understand demand and forecasting

Accurate estimates of what you will need are the backbone of good inventory management. It can seem like guesswork when first starting a business (see our guide on doing your first sales forecasts) – but it doesn't have to stay that way.

Use your sales records to figure out what's hot and what's not. As time goes by, break sales down into daily, monthly, and quarterly reports so you can spot patterns. Use that as a guideline for placing your orders. You can overlay considerations like promotions, economic conditions, holidays and so on – but use past experience as a basis.

3. Allow for lead times

You can't always pick up the phone and order more inventory for tomorrow. Find out how long it takes to replenish certain supplies and factor it into your inventory management. It's a simple step but it can help stop you from making the same mistakes over and over again.

Ten ways to look after your inventory

You wouldn't leave a big pile of money in the middle of your shop floor, unattended and unprotected, right? Since inventory has financial value, it's important to look after it sensibly too.

1. Decide who can order the inventory in your company. Restrict purchasing access to those people only.
2. Account for your inventory carefully – make sure you know what it's worth.
3. Decide how to handle products that don't sell. Try to make at least some money from them – sell them at a lower price or bundle them in with other products.
4. Budget sensibly to limit the amount of money spent on inventory. You want a good understanding of how much money you can have tied up in inventory, and make sure you don't go over that.
5. Track the movement of items inside your company, and keep tabs on deliveries you're expecting.
6. Use proper labels and signs, so you and your staff can locate everything in your stockroom.
7. Always use consistent units of measure. For example, don't mix pounds and kilograms.
8. Think about where your fire extinguishers and sprinkler systems are located.
9. Make sure your security and insurance is adequate for the value of the items you're storing.
10. Develop a training plan for new employees to explain how the system works.

4

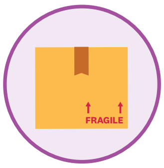
Inventory accounting

Inventory can be a big expense, and a big earner, so it pays to stay on top of the numbers. Besides, you need to report it on your tax return. So let's look at the basics of inventory accounting.

What is inventory accounting?

Inventory accounting helps you figure out how much inventory you have, what it cost you, and what it's worth to your business. It will help you see if your business is performing as well as it could.

How to do inventory accounting



When you buy an inventory item, it is recorded as a cost and an asset. It's an asset because you can sell it.

When you sell that item, it is recorded as income. You also remove it from your list of assets.

This isn't the only way to account for your inventory. Other methods may better suit your business. One alternative is to record your inventory as an asset when you buy it, and only record the cost (along with the income) when you sell it.

Simple, but there's a catch

It can be tricky keeping tabs of what you paid for things when prices change all the time. Accountants have two methods for working around this.

1. Weighted average cost method (AVCO)
For each product line, you can simply use the average cost per item.

AVCO = Total spent / Number of items bought or made

Multiplying this average cost by the number of items you have will tell you the rough value of your inventory. AVCO is a straightforward method, but it leaves out some detail and doesn't work very well when there are big price fluctuations.

2. First in, first out method (FIFO)
You can assign a specific value to each item in your inventory using FIFO accounting.

1. Record the cost of each new item as it comes in (the price may change over time).
2. When you make a sale, record what you were paid..
3. And delete the oldest cost from the list.

You assume you sell your oldest items first (although that doesn't have to happen in practice). FIFO gives you a more detailed view of the value of inventory in stock. It also gives you a better view of your profit margin and how it changes over time.

What about cost of goods sold?

It's important to know the value of the inventory you're holding in stock. But it's also important to know the value of the inventory you've sold. That information will help you get a sense for how much money the business is making.

That's where cost of goods sold (COGS) comes in.

COGS = beginning inventory + purchases - ending inventory.

This formula tells you how much inventory you had to buy in order to earn your sales revenue. Most businesses use this simple COGS formula for inventory accounting. When it comes to working out your profit, you can dig into more detail by factoring in things like storage and handling costs. See more on COGS in our guide to starting a business.

What is stocktaking?

Stocktaking is used to double-check the numbers in your financial records. You do this by physically counting every item of inventory in your possession.

Compare that number to what you have on your balance sheet. They won't often match up. Generally there will be less in reality than on the books. That missing inventory is generally assumed to have been damaged and dumped, or stolen.

Why is stocktaking important?

You may be required to do a stocktake before submitting your business tax return. Besides that, it's a really good way to check and correct your financial numbers.

How often should I do a stocktake?

Tax authorities may require you to do a stocktake at the end of the financial year. Some businesses do it far more often than that. For example:

- retail businesses may do it quarterly (if they sell seasonal goods)
- hospitality businesses often do it once a month
- manufacturers of perishable foods may do it even more frequently

Alternatives to stocktaking

If the numbers of a physical stocktake closely match the numbers in your financial records, you may be able to wait longer till your next one.

Computerised inventory systems can sometimes deliver this level of accuracy. They automatically count inventory as you order it, and subtract it when you sell it. You can complement this technology with cycle counts, where you do a physical count of a few random product lines to check that your book records reflect reality.

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Inventory management systems

You already know inventory management is vital to a healthy business. So let's look at systems you can use for costing, reporting, and reordering inventory efficiently.

Periodic inventory system

A periodic inventory system is the most basic and frequently used by smaller businesses. It involves physically counting your inventory – via a good old stocktake – at set periods. You reconcile those numbers against the purchase and sales records in your books.

You can read more about stocktaking in chapter 4 on inventory accounting.

Perpetual inventory system

Under a perpetual inventory system, you update records as each item of inventory is purchased or sold.

This is generally done by software. You place your orders through the system, so it knows what you've ordered. And you link it to your point-of-sale (or invoicing) systems, so it knows what you've sold.

It does all the maths of AVCO or FIFO accounting in real time, so you'll see how much money you're making on each sale.

You will still need to do occasional stocktakes to confirm the system is working properly – and to complete annual tax returns.

Which is the best inventory management system for you?

Periodic inventory management may be enough for businesses that only sell a few products. It will show you broadly how much inventory costs your business and will allow you to complete annual accounts.

But if your product range or sales volumes grow, or you have a number of locations, periodic inventory management will begin to slow you down. Plus you will find it difficult to do the more precise FIFO accounting.

A perpetual inventory management system will give you a real-time view of your margin while giving you back a lot of the time normally spent on stocktakes.

Starting with periodic, and switching to perpetual as you grow, is a smart option. To make it easier to do, set up your other business systems to accommodate a switch at some point in the future. Get a point-of-sale (or invoicing) system that can integrate with inventory apps. Do the same when you choose accounting software.

Periodic inventory management: pros and cons

Pros	Cons
Don't need to pay for or learn software	Can't get accurate numbers until the end of the accounting period
Suitable for small quantities of inventory	Gets more time consuming as your business grows
Keeps accounting records simple	Makes it harder to do precise FIFO accounting

Perpetual inventory management: pros and cons

Pros	Cons
More accurate and efficient reordering	Still need occasional manual stocktakes for validation and tax purposes
Better view of inventory, sales and margin	Greater investment to set up
Easier to track inventory across multiple locations	Need to be mindful of whether ordered inventory has actually turned up
Can check instantly if an item is in stock	
Don't have to spend time on stocktakes	
Can handle larger quantities of inventory	

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Inventory management software

Inventory management software may give you the time to take stock in another sense – by giving you time to spend with your family, or develop a plan to take things to the next level.

Scan new items as they arrive into the warehouse and the software will automatically add them to your inventory.

Items are removed from inventory as they're processed through your point of sale system.

What does inventory software do?

At a basic level, inventory software tracks your orders and sales to work out what your inventory is. This is also known as a perpetual inventory system.

When well run, these systems can:

- show your inventory levels at any time
- reorder inventory for you
- show you how much each product is making for your business.

How does inventory software work?

Inventory software works by recording your inventory when it comes in – either through manual data entry or through a system such as:

- barcode scanning
- SKU numbers (stock keeping unit)
- serial numbers
- RFID (radio frequency identification) tags
- QR (quick response) codes
- NFC (near field communication) tags

When an item is shipped or sold, your invoicing or point-of-sale (POS) software identifies the item and adjusts the inventory records automatically. Think about the scanner at the supermarket checkout – that's part of an inventory management system.

Once it knows what inventory you do or don't have, the software is able to do a number of other things, depending on its features.

What to look for in inventory management software

You might be able to use your accounting software for inventory management as many packages come with inventory management capability built in. So before you go spending money on a bells and whistles piece of inventory management software, check what you actually need and if your accounting software can do the following:

- provide you with real-time data
- streamline reordering with low inventory alerts
- integrate and automate all the tasks from quoting to ordering to billing to shipping
- manage multiple locations from anywhere
- integrate with POS software
- scan barcodes, QR codes or read RFIDs
- forecast seasonal demand
- manage batch and expiry dates and lot tracking
- handle returns and exchanges
- attach documents such as photos and supplier contracts
- integrate with ecommerce software
- scale-up as your business grows
- stocktaking functionality

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Where to next? Tools and guides by Xero

You've got a lot of things to juggle when running a business. Inventory management is just one. Software can make it easier for you to keep all the balls in the air with many tasks being automated. Let Xero help.

Handy tips and tricks for your business

Xero has a host of useful guides on small business topics like marketing, invoicing, payroll, bookkeeping and more. Take a look at some of them for yourself.

Browse small business guides

Discover more about Xero

At its heart, Xero is accounting software. It will help you keep on top of the numbers. But it also connects with more than 700 other business apps to support sales, marketing, inventory management, and more.

If you're keen to learn more about Xero, check out these resources:

- Xero features
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