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MANU		VINU			
		<b>CONVERSATION BETWEEN MANU AND VINU ABOUT <u>INVENTORY TURNOVER RATIO &amp; HOLDING LEVEL</u></b>			
Manu	Hi Vinu!				
Vinu	Manu! I am desperately waiting for you!				
Manu	Why? What's the matter?				
Vinu	My Boss and his brother started business at same time.				
Manu	Yes. I Know!				
Vinu	They are into -same line of business; -same investment; -same experience; -same market; - same sales.....				
Manu	Ya Ya...everything same...come to the issue jaar!				
Vinu	Yes! When everything is same, why our Boss's business is reports poor profits, whereas his brother is doing remarkably well with good profits?				
Manu	Hmmm...there may be many reasons – let's try to evaluate.				
Vinu	Please help Manu.				
Manu	The Problem can be identified to some extent by evaluating Turnover Ratios like Inventory Turnover and Receivables Turnover Ratios.				
Vinu	Turnover Ratios?				
Manu	Ya Vinu. Let us evaluate Inventory first - What's the average inventory maintained by your Boss?				
Vinu	He always maintains around Rs.25 Lakhs worth of Inventory.				
Manu	Hmmm...that information alone will not help ....What is the cost of goods sold per annum?				
Vinu	It is around Rs.50 Lakhs.				
Manu	Then here lies the problem.				
Vinu	What's that?				
Manu	Inventory turnover ratio is very low.				
Vinu	How do you say that?				
Manu	Look! Your one full year cost of goods sold is Rs.50 Lakhs and your Boss's keeps around average inventory of Rs.25 Lakhs. It means, your inventories are not getting consumed or sold.				
Vinu	It's not clear.				
Manu	Your inventory is getting rotated only twice in a year. Understand the Key. Inventories are meant to be consumed / sold. It is only when inventory goes out of your business, you make profit. If you keep inventories with yourself, it is going to incur only cost for you.				
Vinu	Correct! With every sales, inventory comes down and profit goes up.				
Manu	By keeping inventory with yourself, you are attracting lot many cost.				
Vinu	Like?				

Manu	You have to keep inventory in safe place, then you need people to take care of storage and management – all these will result in Storage Cost.																				
Vinu	Correct!																				
Manu	If you are investing money in Inventory, that money is not going to come back until those inventories are sold and cash is realised. But, you can't afford to wait such long.																				
Vinu	Ya!																				
Manu	So, you have to arrange for alternate funds – either Bank funds like Cash Credit or Owners Funds.																				
Vinu	True!																				
Manu	These funds will not come free. They have a cost. It means, you have interest cost (bank loan) or opportunity cost (own funds) on the alternate funds.																				
Vinu	Very True!																				
Manu	So, if your inventory holding is very high, you will have high storage cost and opportunity cost. One relief with high inventory can be lower ordering cost.																				
Vinu	Ya! I remember all this – I have studied them in Cost Accounting – Economic Order Quantity																				
Manu	You are right. Let's come back. In your case, your Boss keeps Inventory worth Rs.25 Lakhs, when cost of goods sold is Rs.50 Lakhs																				
Vinu	Ya!																				
Manu	It means Inventory Turnover Ratio is only 2 Times.																				
Vinu	How did you got that?																				
Manu	Inventory Turnover Ratio = Cost of Goods Sold / Average Inventory																				
Vinu	Ok																				
Manu	Here, Inventory Turnover Ratio = 50 L / 25 L = 2 Times																				
Vinu	Ya																				
Manu	It means your inventory is getting rotated only two times in a year.																				
Vinu	It means every six months?																				
Manu	Just imagine, you are going to wait for six months to sell your stock and wait for another six months to sell your next set of stock.																				
Vinu	Noooooooooooooooooo.....																				
Manu	That's what happening with your boss. He keeps stock equivalent to six months of cost of goods sold.																				
Vinu	But why?																				
Manu	Exactly. That's my question. When he understands he can sell only for Rs.50 Lakhs per year, why he should keep inventory worth Rs.25 Lakhs. He should change his Inventory Policy.																				
Vinu	I am getting this.																				
Manu	Ideally, he should keep only 1 to 1 ½ Month level of inventory. This is just a thumb rule applicable for most of business (of course with some exceptions) and not based on empirical study.																				
Vinu	You mean to say, he should keep only around Rs.6.25 Lakhs worth of Inventory, if he is going to follow 1 ½ Months Inventory Policy.																				
Manu	Yes! You are right! If your annual cost of goods sold is Rs.50 Lakhs (for 12 months), then 1 1/12 months Inventory should work out to Rs.6.25 Lakhs (1.50x50/12)																				
Vinu	But what is the benefit?																				
Manu	Let's see the benefit here.																				
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	By Changing your Inventory level from 25 Lakhs to 6.25 Lakhs, you release 18.75 Lakhs of locked investment back to your business. This will improve liquidity.																				
Vinu	Correct.																				
Manu	Your storage cost is going to come down as you don't need such large space.																				

Vinu	True.												
Manu	Your Interest cost on alternate funds are going to come down because your requirement for alternate funds have come down drastically to 6.25 Lakhs. You have pay, let's assume, @ 14%. For existing you should pay Rs.3.50 Lakhs but for the proposed level, your interest obligation is only Rs.87,500/- It is a huge saving.												
Vinu	I agree.												
Manu	So, this reduction in Storage Cost and Interest cost will reflect on your profit.												
Vinu	But what about ordering cost?												
Manu	Yes! There will be increase in ordering cost but it is not going to be that significant as it involves only clerical cost.												
Vinu	OK.												
Manu	So, understand, you can improve the profit of the business without increasing sales but just by altering your inventory holding.												
Vinu	Now what will be the Inventory Turnover Ratio?												
Manu	Let's calculate that also												
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i) Cost of Goods Sold	50 Lakhs	50 Lakhs											
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iii) Inventory Turnover Ratio (i/ii)	2 Times	8 Times											
Vinu	Wow... Inventory Turnover Ratio improves to 8												
Manu	Yes! So what you can infer is, - If Inventory T/O Ratio is low – it will result in liquidity issue and poor profit												
Vinu	Correct! And if it is high, it will result in improved liquidity and Profitability												
Manu	Exactly!												
Vinu	Is it possible to calculate Inventory holding period using Inventory Turnover Ratio?												
Manu	Yes Vinu! Take Existing Case – inventory Turnover Ratio is 2 Times. Simple divide No. of days / months in a year by Inventory Turnover Ratio to arrive at Inventory Holding Period.												
Vinu	Inventory Holding Period = No. of Months / Inventory Turnover Ratio <b>Inventory Holding Period = 12 / 2 = 6 Months</b>												
Manu	Good! And it tallies with our initial details!												
Vinu	Yes! And for Proposed level, Inventory Holding Period = No. of Months / Inventory Turnover Ratio Inventory Holding Period = 12/8 = 1.50 Months Hurraayyyy!!!												
Manu	Ha ha...This is just one aspect where you can do wonders in your profit without altering your Sales.												
Vinu	So Receivables turnover ratio will also influence profits?												
Manu	Yes! Very much! Ill explain that after some time ☺												
Vinu	Ok Manu! No Probs ☺												

**Author:**

**CA N Raja**

**Chartered Accountant**

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