Inventory ratios case study example

Business, Company



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Introduction

The total amount of goods in stock is known as inventory. Maintaining inventory involves cost in the form of storage cost and blocking of working capital limit. Not maintaining sufficient inventory may lead to loss of sales and profits. Hence, companies optimise their inventory level to ensure smoothing functioning of business. Strategies of inventory management can be better understood by analysing the case of Dell and HP.

CP 7-4 Inventory Ratios of Dell and HP

On analysis of inventory levels of Dell and HP in the given question, it is evident that the two companies adopt different strategies of inventory management. The same is discussed here in line with the questions asked.

Question a. Determine the inventory turnover ratio and number of days' sales in inventory ratio for each company.

Johnson and Malucci (1999) define inventory turnover ratio as the ratio of cost of goods sold to average annual inventory investment. Hence, before calculating the inventory turnover ratio, it is required to calculate the average inventory. Average Inventory is calculated by taking the average of the beginning inventory and the ending inventory.

Average Inventory for Dell = (Beginning inventory + Ending inventory) \div 2

 $= (1180+867) \div 2 = \$ 1023.5$

Average Inventory for HP = $(7879+6128) \div 2 = \$ 7003.5$

Now, calculating inventory turnover ratio for Dell and HP:

Inventory Turnover Ratio for Dell = Cost of Goods Sold ÷ Average Annual Inventory

 $= 50144 \div 1023.5 = 49.0$

Inventory Turnover Ratio for HP = $87524 \div 7003.5 = 12.5$

Jesswein defines number of days' sales in inventory ratio as average inventory divided by daily cost of goods sold. Daily cost of goods sold is calculated by dividing cost of goods sold by 365. Effectively, it is 365 divided by inventory turnover ratio. Calculating the ratio for Dell and HP:

 $= 365 \div 49.0 = 7.4$

Question b. Interpret the difference between the ratios for the two companies.

The inventory turnover ratio is much higher for Dell than for HP. According to Johnson and Malucci (1999), inventory turnover ratio is an indicator of how well inventory is being used. A higher ratio means lesser cost incurred in carrying inventory. This is also evident from the number of days' sales in inventory. While Dell maintains inventory for about seven days, HP maintains it for about a month. This increases the cost of carrying inventory. A company has limited funds. If more funds are utilised for maintaining inventory, less funds will be available for other investment purposes. Higher levels of inventory may also indicate that sales are poor or the company is

not able to forecast demand with accuracy.

It is also to be noted that maintaining lesser inventory would mean taking the risk of unmet customer demands and loss of sales. It may adversely impact a firm's profits due to sudden upsurge of demand.

Conclusion

There is a trade-off between incurring high inventory carrying costs and loss of sales. Different companies have different strategies. While some focus on lean inventory management, others focus on meeting customers' demands even during sudden upsurges. In spite of different strategies, companies strive to reduce their inventory levels over the period of time through incorporation of new process and technology.

References

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