

# What is Inventory Management? Techniques for 2020

Learn everything you need to know about inventory management with our free series of comprehensive guides. Let's start at the beginning.

In this guide:

- What is inventory management?
- How does inventory management work?
- Five key stages of inventory management
- Why is inventory management important?
- How to improve inventory management
- 8 common inventory management techniques
- How to grow your inventory management skills
- Glossary and key formulas

## What is inventory management?

Inventory management is how you track and control your business' inventory as it is bought, manufactured, stored, and used. It governs the entire flow of goods — from purchasing right through to sale — ensuring that you always have the right quantities of the right item in the right location at the right time.

## What is inventory?

Inventory is the goods that your company handles with the intention of selling. It might be raw materials that you buy and turn into something entirely new, or it might be a bulk product that you break down into its constituent parts and sell separately. It could even be

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something completely intangible: software, for instance.

## Types of inventory

There are lots of different types of inventory, and which ones you'll deal with depends on the goods you sell. Here's an overview of some of the types you're more likely to encounter:

- **Finished goods/for-sale goods:** The products you sell to your customers
- **Raw materials:** The inventory you use to make your finished goods
- **Work-in-progress:** Essentially, unfinished goods — inventory that is part-way through the manufacturing process
- **MRO goods:** MRO stands for maintenance, repair and operating. This is the inventory you use to support the manufacturing process
- **Safety stock:** The additional inventory you keep in store to deal with supplier shortages or surges in demand

Every venture that handles inventory will need some way of handling stock. Let's take a look at how that works in principle.

## How does inventory management work?

At a basic level, inventory management works by tracking products, components and ingredients across suppliers, stock on hand, production and sales to ensure that stock is used as **efficiently and effectively as possible** (/blog/a-basic-guide-to-streamlining-your-inventory-management). It can go as deep as you need it to: for example, by examining the difference between dependent and independent demand, or forecasting sales to plan ahead. But at the end of the day, it all goes back to your stock.

### Example: Sam's chairs

Sam decides to set up a business selling her handcrafted dining chairs. Each chair she makes requires 6 different sizes of wood, plus a cushion. She goes to her supplier and buys 10 planks of each size of wood she needs, plus 10 cushions. These are all now included in her business' inventory.

As she turns raw materials into chairs, then sells them, Sam's inventory levels will change. She'll need to keep track how much of each material she has at any one time, how many chairs she can make, how fast she can make them, where her materials are, how many chairs she is selling and much more. This is all inventory management.

Don't worry if that seems daunting — inventory management is much easier to digest once you break it down into the 5 key stages that your goods will go through.

## Inventory management process: 5 key stages

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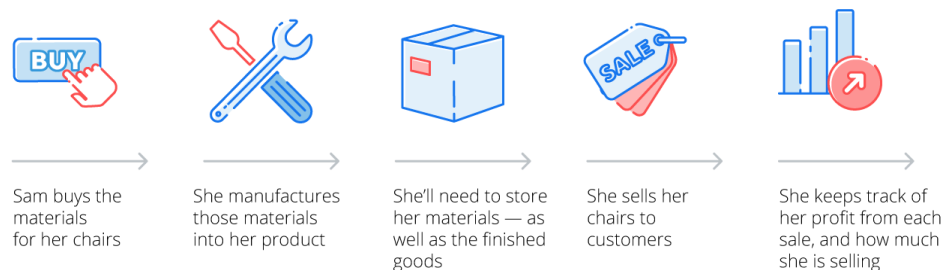
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The inventory management process (/blog/4-best-practices-inventory-stock-management) involves tracking and controlling stock as it moves from your suppliers to your warehouse to your customers. There are five main stages to follow:

1. **Purchasing:** This can mean buying raw materials to turn into products, or buying products to sell on with no assembly required
2. **Production:** Making your finished product from its constituent parts. Not every company will get involved in manufacturing — wholesalers, for instance, might skip this step entirely
3. **Holding stock:** Storing your raw materials before they're manufactured (if required), and your finished goods before they're sold
4. **Sales:** Getting your stock into customers' hands, and taking payment
5. **Reporting:** Businesses need to know how much it is selling, and how much money it makes on each sale/li>

Continuing with our example from earlier, here's how Sam's company utilises each stage of the process:



## Inventory management vs. inventory control

While they may sound similar, inventory control is a key part of inventory management, but it isn't the same thing (/blog/inventory-control-inventory-management-two-different-things).

## What is inventory control?

Inventory control is how you manage the stock you currently have in storage. This involves knowing your stock inside and out — how much is available, where it is and what condition it is in. It's also about ensuring that you are storing stock efficiently, keeping inventory costs down and minimising the time spent counting and controlling inventory.

Learn more about inventory control (/inventory-management-guide/inventory-control).

## Which comes first — management or control?

Inventory management is much broader than control: it takes your supply chain, manufacturing, fulfilment, sales and reporting into account. Almost any business will have to get an inventory management system in place before they drill down to control. Otherwise, you'll have no way of managing suppliers, production or sales.

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After that, there are countless methods for storing and selling your products better. Whether you focus on optimising purchasing, control, production or sales is up to you. You might, for instance, want to plan improvements based on previous operating experience — say, by changing how you count stock. Or you might want to tweak processes to reflect product and order profile changes, customer gains and losses or shifts in demand.

## Why is inventory management important?

Inventory management dictates how you run your business, serve your customers and grow sales. For businesses based around selling products – from craft breweries to big wholesale distributors – managing inventory efficiently is crucial. Here are three key reasons why.

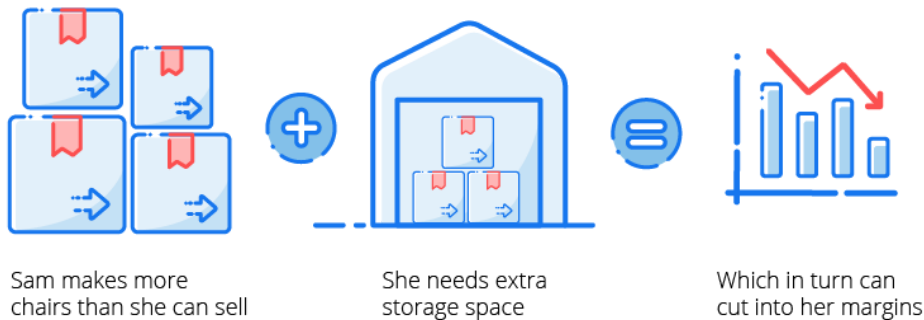
### Run your business smoothly

If your business doesn't [manage its inventory properly \(/blog/six-essential-techniques-for-better-inventory-management/\)](/blog/six-essential-techniques-for-better-inventory-management/), it will quickly fall apart.

Find out more:

- [Typical inventory mistakes \(/blog/3-inventory-management-mistakes/\)](/blog/3-inventory-management-mistakes/)

Sam, for instance, needs to match her supply of materials and production to customer demand. If she makes more chairs than she can sell, she'll need to find somewhere to store the excess: which could end up cutting into her margin. On the other hand, if she runs out of any one of her raw materials, production will cease entirely until she restocks.



Many [small businesses \(/blog/inventory-management-tips-small-businesses-start-ups/\)](/blog/inventory-management-tips-small-businesses-start-ups/) rely on manually counting stock to track what's in store. But stock counts are disruptive and time-consuming, taking time away from making and selling products. So putting a system in place that doesn't require stocktakes for accurate figures is imperative.

Find out more:

- [Matching product supply to demand \(/academy-portal/video/tips-help-match-product-supply-customer-demand/\)](/academy-portal/video/tips-help-match-product-supply-customer-demand/)
- [Inventory management and quality control \(/blog/putting-two-together-manufacturing-inventory-management-quality-control/\)](/blog/putting-two-together-manufacturing-inventory-management-quality-control/)

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- The effects of stockouts on a business (/blog/evaluating-knock-effects-inventory-stock-outs-business)
- Three signs that it's time to rethink your stock control (/blog/3-signs-time-rethink-stock-control)

## Keep customers happy

Inventory management dictates:

- How quickly you can get your products to your customers
- How reliably you can fulfil orders
- How much visibility you can give your customers

Customers will be much more likely to come back for more if they know your organisation can consistently deliver orders on time and let them know what's available. This is especially true when it comes to business-to-business transactions. For a consumer, a missed deadline might mean an inconvenience. For a business, it can mean lost sales and profits.

Find out more:

- Three measures of customer satisfaction (/blog/three-measures-customer-satisfaction-compared)
- Why NPS is important (/blog/nps-important-customer-satisfaction)
- Improving customer satisfaction (/blog/good-great-improving-customer-satisfaction)
- Five ways that inventory management improves customer satisfaction (/blog/five-ways-inventory-management-improves-customer-satisfaction)

## Grow your company

As businesses grow in complexity, their inventory management needs get more complex as well. When Sam adds new product lines, hires staff, opens new production facilities and grows her customer base, the organisation of materials and stock will get harder.

That makes it important to get control over your physical inventory from day one if you plan on scaling. Rapid growth tends to bring a lot of time consuming tasks: hiring staff, moving to bigger premises and negotiating with new suppliers. So putting an effective stock system in place early is key. The later you leave it, the longer it will take — and you'll have less time to do it.

Find out more:

- [Five hurdles to business growth \(/blog/five-hurdles-business-growth\)](/blog/five-hurdles-business-growth)
- [The five stages of SME growth \(/blog/five-stages-sme-business-growth\)](/blog/five-stages-sme-business-growth)
- [How to scale sustainably \(/blog/basic-principles-sustainable-business-growth\)](/blog/basic-principles-sustainable-business-growth)
- [How inventory management can encourage growth \(/blog/encouraging-growth-business-inventory-management\)](/blog/encouraging-growth-business-inventory-management)
- [Overcoming growing pains \(/blog/scaling-overcoming-growing-pains-business\)](/blog/scaling-overcoming-growing-pains-business)

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But these aren't the only **advantages of inventory management** (/blog/benefits-strong-inventory-management-system). It can also bring several direct benefits to your business' bottom line:

- Make it easy to add new products and channels, analyse performance and empower salespeople with up-to-date product information, so you can **grow sales revenue**
- Eliminate the inefficiencies that lead to lost stock, overstocking, and stockouts — **reducing holding costs** and **growing margins**
- Reduce the time and manpower spent on inventory admin, **saving on staff costs**

Find out more about **inventory management strategy** here (/blog/strategic-inventory-management).

## How to improve inventory management

### 1. Focus on your needs

A warehouse full of inventory can be a daunting task. One way of making managing it all easier is to identify the items that are the most important and focus on them first. It's highly unlikely that every item in your warehouse will have the same demand from customers. Keep the top-selling items in stock, and you'll have made a great start at keeping your customers happy.

### 2. Engage with suppliers

In any stock-based business, it is crucial to manage supplier relationships well. Developing constructive relationships with your business' key suppliers is important to secure reliable supply, unlock competitive pricing and to understand emerging trends that may impact your business.

### 3. Develop an inventory management system

How your business deals with order quantities, replenishment cycle times, safety stock, forecasts, seasonality and more is important. Tweak each operation according to your specific business — making sure to keep track of what works and what doesn't. **Making a dramatic improvement** (/blog/art-improving-inventory-management) in one area can be better than a few small improvements across the board.

### 4. Utilise real-time data

Information is a powerful tool, but only when it's accurate and up to date. Real-time data and analytics — from layered inventory tracking right through to forecasting data, automatic ordering and individualised safety stock — can make a real difference to your business. For the most accurate data, consider using perpetual inventory management software, as it is the best way to ensure the information you need is always at your fingertips.

### 5. Go mobile

Mobile technology has revolutionised inventory management. Barcode scanning, for example, makes receipting and tracking goods far faster — and helps eliminate unnecessary errors. Sales apps, meanwhile, empower salespeople with inventory data on

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the road. You no longer need to be tethered to a computer in your warehouse. You can keep track of key business processes from home, on holiday, or wherever you are.

## 6. Develop an inventory management system

Managing your inventory on an ad-hoc basis will only ever get you so far. To really keep on top of your stock, you'll need an inventory management system.

Every company will have its own unique needs, so picking a system that matches your business is important. In the early days of her company, for example, Sam might be able to manage her inventory using spreadsheets. But a global stock-based business like Amazon requires a bespoke, multifaceted solution that caters to the huge number of orders processed every single day.

## Inventory management techniques

No matter the size of your business, employing some of these common inventory management techniques can be a great way to take control of your stock. Here are a few to consider:

- **Just-in-time (JIT) inventory** (/blog/just-time-inventory-streamlined-inventory-management). JIT involves holding as little stock as possible, negating the costs and risks involved with keeping a large amount of stock on hand
- **ABC inventory analysis** (/blog/using-abc-analysis-make-inventory-work). This technique aims to identify the inventory that is earning you profit, by classifying goods into different tiers
- **Dropshipping** (/blog/inventory-management-drop-shipping-success). Businesses that use dropshipping essentially outsource all aspects of managing stock — with several benefits but a few key drawbacks
- **Bulk shipments**. This technique is based on the assumption that buying in bulk is cheaper. The method is great if a business is sure that their products will sell but can pose challenges when demand suddenly changes
- **Backordering**. A backorder is when a customer places an order for stock that is not yet available. Learn more about how backordering impacts inventory control
- **Consignment**. This technique allows a consignor, usually a wholesaler, to give their goods to a consignee, usually a retailer, without the consignee paying for the goods up front. The consignor still owns the goods, and the consignee pays for the goods only when they actually sell. This sounds great but it also carries major risks
- **Cross-docking**. This system virtually eliminates the need to hold inventory. Products are delivered to a warehouse where they are sorted and prepared for shipment immediately. They are usually reloaded into other trucks at the same warehouse and sent out for delivery immediately
- **Cycle counting**. This technique involves counting a small amount of inventory on a specific day without doing an entire stocktake. This method helps your business regularly validate accurate inventory levels in your inventory management software

Learn more about JIT, ABC analysis and dropshipping here (/blog/3-inventory-management-techniques-every-business-should-consider).

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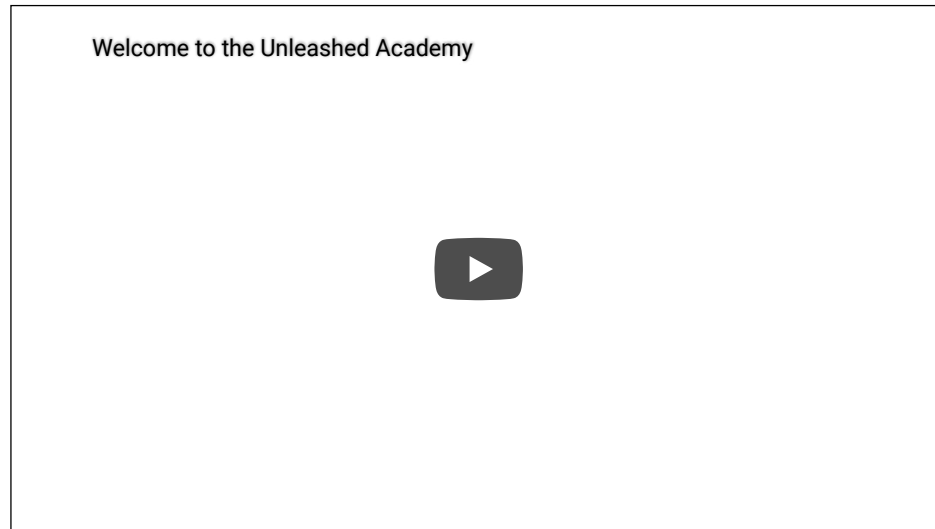
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# Develop your inventory management skills

Use the **Unleashed Academy** video training series (</academy>) to learn more about inventory management and put your knowledge into practice.



## Inventory management glossary

Let's look at some of the basic terminology and formulas you need to know before diving deeper into **inventory management systems** (</inventory-management-guide/inventory-management-systems>).

### Cost of goods sold

Cost of goods sold (COGS), otherwise known as cost of sales, refers to the direct costs of producing goods. This includes the cost of the materials and labour directly used.

### Days inventory outstanding (DIO)

Days Inventory Outstanding, also known as Days Sales of Inventory, is used to measure the average number of days a company holds inventory before selling it.

### Economic order quantity (EOQ)

The economic order quantity is the optimal order quantity at any given point in time. An optimal EOQ minimises total holding and ordering costs. It is sometimes known as the optimum lot size.

### Finished products

Finished products, or finished goods inventory, refers to the number of manufactured products in stock that are ready to sell.

### Inventory accounting

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Inventory accounting deals with valuing and accounting for changes in assets. Inventory involves goods in three stages of production: raw goods, in-progress goods, and finished goods. An accurate inventory accounting system keeps track of changes to inventory at all three stages and adjusts asset values and costs accordingly.

## Inventory costs

Inventory costs are the costs associated with procuring, storing and managing inventory. They can be categorised into one of three types: ordering costs, carrying costs and shortage costs.

## Inventory management software

A software system for tracking inventory levels, orders, sales and deliveries. It can also be used in production to create a bill of materials and other production-related documents.

## Lead time

In an inventory management context lead time is the period between an order being placed to replenish inventory and when the order is received.

## Point of sale

The point of sale, or point of purchase, is the time and place in which a retail transaction is completed. It usually involves an invoice and options to make payment.

## Purchase order

A purchase order is a document created by a buyer and sent to a vendor requesting goods or services. The buyer will, at a minimum, specify what products are being ordered, the quantity, the agreed price, and delivery and payment terms.

## Reorder point

This is the level of inventory which triggers an action to replenish it. It is a minimum amount of stock a business needs to have, such that, when stock falls to this amount, the item must be reordered.

## Safety stock

This refers to a buffer or reserve of critical stock that is held to protect against unforeseen supply or demand pressures.

## Sales channels

A way of bringing products or services to market so that consumers can buy them. Sales channels can be direct if it's selling directly to consumers, or indirect if an intermediary is involved.

## Stock levels

Otherwise known as inventory levels, stock levels are the quantity of goods or raw materials kept on the premises of a business.

## Supply chain

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A supply chain is a system of organisations, people, activities and resources involved in supplying a product or service to a consumer.

## 4 fundamental inventory management formulas

For new business owners, the following calculations might seem daunting, but don't let that deter you. These formulas are essential for keeping stock levels optimised. Let's explore:

1. The Economic Order Quantity (EOQ) formula
2. The Days Inventory Outstanding (DIO) formula
3. The safety stock formula
4. The reorder point formula

### Calculating Economic Order Quantity (EOQ)



$$EOQ = \sqrt{(2DK/H)}$$

It's important to buy the right amount of inventory stock – neither too little, nor too much. You use the EOQ formula to determine the optimal order quantity – one that minimises the costs of ordering, receiving and holding inventory.

Where:

- D is the setup cost per order; this typically includes shipping and handling costs
- K is the demand rate (your quantity sold per year)
- H is the holding cost per year per unit

### Calculating Days Inventory Outstanding (DIO)



$$DIO = (\text{Average inventory}/\text{COGS}) \times \text{Days in period}$$

The Days Inventory Outstanding formula goes a step further than the inventory turnover ratio by putting the figure into a daily context and providing a more accurate picture of a company's inventory management and overall efficiency. Generally a low DIO is preferred

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but to make sense of it, you need to take into account the industry and market dynamics.

Where:

- Average inventory = (Beginning inventory + Ending inventory) / 2
- COGS is your cost of goods sold
- Days in Period is the number of days in the timeframe that you want to measure, whether it's weekly, quarterly or annually

## Calculating safety stock



$$\text{Safety stock} = (\text{Maximum daily usage} \times \text{Maximum lead time in days}) - (\text{Average daily usage} \times \text{Average lead time in days})$$

Knowing how much buffer stock to hold will help your business navigate safely through demand and lead time fluctuations. It might seem daunting but all you need to know are your purchase and sales orders history.

## Calculating reorder point



$$\text{Reorder point} = (\text{Average daily usage} \times \text{Average lead time in days}) + \text{Safety stock}$$

You use the reorder point calculation to determine when to reorder stock. Small business owners often rely on intuition and past experience to know when to place another order, but as the business grows, this quickly becomes unsustainable.

## What are inventory costs?

Knowing your inventory costs helps you make smarter decisions. There are three broad categories of inventory costs: **ordering costs**, **carrying costs**, and **shortage costs**.

### Inventory ordering costs

This is the expense incurred in creating and processing an order to a supplier. You'd use this to determine the EOQ of your inventory. Examples of ordering costs are:

- Cost to prepare a purchase requisition or purchase order

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- Cost of the labor required to inspect receipted goods
- Cost to process the supplier invoice related to an order
- Cost to prepare and issue a payment to the supplier

## Inventory carrying costs

Carrying costs are the expenses related to storing unsold goods. This includes the tangible costs such as storage, handling, and insuring, as well as intangible costs such as depreciation, the cost of deterioration and obsolescence and opportunity costs. Carrying costs will generally comprise 20% to 30% of a business' total inventory costs.

## Inventory shortage costs

Also known as stock out costs, this is the expense that arises from an out-of-stock situation. This can include measurable costs such as the cost of expedited shipping, buying last minute from another supplier, or loss of the margin on incomplete sales. These also include costs that are hard to quantify such as loss of customer confidence or loss of customers, idle employees and loss in goodwill.

Learn more about [inventory costs \(/blog/what-are-inventory-costs\)](/blog/what-are-inventory-costs).

## Next steps

Deciding when you might need dedicated inventory management software is a key step in the growth of your company. To find out more about how to manage your inventory better, take a look at [our guide to inventory management systems \(/inventory-management-guide/inventory-management-systems\)](/inventory-management-guide/inventory-management-systems). Or if you'd like more information on the fundamentals of stock, read our [inventory management basics blog \(/blog/basic-inventory-management\)](/blog/basic-inventory-management).

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