Inventory can tie up a substantial amount of capital, especially when it comes to your Parts Department. If your inventory is slow moving, this money will continue to stay tied up, giving you less money to invest in other areas of the business.

Not only this, but the longer your parts inventory sits on the shelf, the more likely it is to become obsolete, decreasing the likelihood that you will be able to make back the money you have invested, possibly even losing it all together.

The best way to determine how well your parts are moving, so that you can make the best decisions possible when it comes to investment and purchases, is to determine your inventory turnover ratio.

You inventory turnover ratio shows how many time your parts are sold or replaced over time.

To determine your inventory turnover, you need to divide your cost of goods sold (COGS) during the year by the average inventory value during the year.

Inventory Turnover = COGS / Average Inventory Value

Your COGS will be found on your income statement, whereas the average inventory will be calculated. To calculate average inventory, add your beginning and ending inventory balances for the year (found on your balance sheets) and divide the result by 2.

Average Inventory Value = (Beginning Inventory + Ending Inventory) / 2

To determine how frequently your inventory turns, in terms of days, divide 365 days by the result of your inventory turnover ratio calculation.

Days in Inventory = 365 days / Inventory Turnover

Example - if you have $4,000,000 in COGS and an average inventory cost of $1,000,000 your inventory ratio would be 4 ($4 million / $1 million). That means that you turn over your inventory every 91.25 days (365 / 4).

Inventory Turnover = COGS / Average Inventory Value
Inventory Turnover = $4,000,000 / $1,000,000 = 4

Days in Inventory = 365 days / Inventory Turnover
Days in Inventory = 365 / 4 = 91.25 days

Evaluating Results

The higher your inventory turnover ratio, the more quickly parts are moving off your shelf.

To effectively evaluate your inventory turnover ratio, you should compare it to past ratios within your company, future goals and the average industry turnover.

In 2017, the average inventory turnover for auto parts and accessories was 3.8, according to The Retail Owners Institute.

Downfalls of Inventory Turnover

While your inventory turnover ratio can offer a number of insights into your ability to sell parts quickly and to fulfill customer's orders, it does have some qualifiers.

The most common of which is that the inventory turnover ratio is calculating the average turnover of ALL your parts.

As a result, a favorable overall inventory ratio does not mean that you are free and clear of excess parts and obsolescence.

When turnover is too high, you run the risk that you may have too few parts on the shelf. When this happens, you must purchase the parts on an emergency basis, many times paying more for that part than you would have if you would have purchased it from the manufacturer or jobber.

Example - You have a COGS of $4 million and an average inventory cost of $1 million. However, 5 parts account for 40% of the sales but only 10% of the average inventory cost. This would mean that your inventory turnover for these specific parts would be 16 (($4 million x 40%) / ($1 million x 10%)) and that these parts turn every 22.81 days.

The remaining 60% of the inventory would have an inventory ratio of 2.67 (($4 million x 60%) / ($1 million x 90%)) and are turning, on average, every 136.7 days. That is significantly higher than the average 91.25 days, showing that slow moving parts can be hidden by the average.

To overcome this limitation, it is important for businesses to look at the turnover ratios for each item sold/held in inventory on a part by part basis. In doing so, you can quickly see which items provide your business with the best turnover and which are at risk for obsolescence.

Sound intimidating? Don’t worry. Most inventory management programs can generate an inventory turnover report for each item in your system, allowing you to analyze your inventory quickly and efficiently.

The important thing is ensuring your inventory records are as accurate as possible, otherwise your data will be skewed. To do so, ensure you do regular inventory counts and reconciliations on all of your inventory.

Reference: https://www.procountwest.com/mikes-blog/the-importance-of-inventory-turnover-and-how-to-evaluate-it