

11.20: Inventory Levels

Learning Objectives

- Summarize how retailers determine product inventory levels



Let's discuss some important characteristics of how retailers determine appropriate inventory levels.

Meet Customer Demand

If you don't effectively plan your inventory levels you won't have an understanding of your potential sales given peaks and valleys within the business to meet customer demand. Those peaks and valleys depend on the type of retailer, the seasonality of the product, and the promotional environment. Valentine's Day product is a great example. There is a relatively short time frame in which any retailer can sell this product category. After February 14th it is likely that the customer will no longer want the products and you will have to markdown any remaining liability to get out of it quickly. Furthermore, if you don't order adequate amounts of inventory for your shelves prior to the holiday you might miss sales. Imagine the impact this has on an area that only has seasonal product for holidays such as Valentine's Day—they could potentially miss the sales plan for an entire year!

Lead Time

Every retailer has to factor replenishment lead times in their inventory plans. Lead times can vary from two weeks to six months or more. Order lead time is the time from the placement of the order with a vendor to when the product arrives at the retailer store or warehouse. Domestic product generally has a shorter lead time while product produced overseas have longer lead times. Depending on the area of business this is a key consideration for product that sells out quickly. It might be a good idea to keep warehouse inventory reserve for those items to replenish back to stores that sell out of product.

Higher Profit

Sourcing and managing inventory has a direct effect on profitability. A retailer is able to increase profitability if they can control inventory levels. Ignoring a proper inventory system in production, sales, and trade will hinder operational efficiency. If a retailer plans inventory levels in line with customer demand they are able to realize less potential markdowns as they will sell thru the merchandise at a reasonable rate. While it isn't possible to meet sales objectives 100% of the time there must be a contingency plan in place. Sometimes it is better to markdown product as quickly as possible when it is determined sales objectives won't be reached to mitigate even more potential risk. In other words, the longer the retailer waits to reduce the price of a slow seller the deeper the discount will need to be.

Better Cash Flow

Policies and procedures for effectively planning inventory levels enable companies to maintain inventory flow, account for inventory value, and handle aged inventory. These are all policies that will enable the company to achieve sales goals and objectives. As a result the retailer is better able to manage cash flow. Why is cash flow important? You might have heard the expression “Cash is King!”. Excellent cash flow works the same way in business that it does for any individual. It allows the retailer to be in a more stable position with regards to spending and buying power. Having cash flow enables any business to generate and use cash. It also allows the retailer to pay any future debts.

For the final segment of this module we will explore the statistical methods the retailer uses to plan inventory levels. These are: forward weeks of supply, weeks of supply, stock-to-sales ratio, sell-through percent, basic stock, and turnover.

Forward Weeks of Supply

An important goal of inventory planning is having enough inventory on hand for the sales planned until the next delivery arrives. This calculation is at the week level and is calculated as the number of weeks of planned sales from the next week forward that current inventory value represents. Using forward weeks of supply is a good metric to make informed merchandise decisions. It gives good insight as to how the product and category will contribute to overall sales and inventory. However, one key disadvantage of forward weeks of supply is it is calculated at a weekly level which doesn't allow for a higher level top-down approach.

Weeks of Supply

Weeks of supply simply looks at past trend versus any future sales projections. Weeks of supply is calculated as the inventory position for a given period divided by the average sales for that same time frame. One huge disadvantage of weeks of supply is it looks at past sales trend to calculate inventory and not future time periods. It shows you where you have been but not where you are going. This is especially important for those businesses and time periods that have huge sales increases. For example, Easter is a time period in which the sales are typically higher. If you calculate weeks of supply during those time frames it would be much lower than an average time period which would, in effect, make it seem as if you have much lower inventory levels based on weeks of supply. The retailer must always take into account the time period when using this method.

Stock-to-Sales Ratio

This is an appropriate measure for planning at the monthly level and is calculated by dividing sales at the beginning of period into inventory for that same time period. Stock to sales ratio provides the retailer with an estimated annual turn. However, this measure only looks at one distinct time period and fails to look at the trend over time.

Sell Thru Percent

Sell thru is one of the most common metrics for retailers to understand performance and inventory levels. It represents the ratio of sales to beginning inventory. It is calculated by dividing sales by beginning inventory. This metric, like stock-to-sales ratio, looks at sales in relation to inventory for one period of time as opposed to a longer time period. However, it is useful for understanding performance as well as possible inventory needs. For example, if Product A has a sell thru of 10% and the average for the department is 3%, that is an indication that you need to procure more inventory for Product A to maximize sales potential.

Turnover

This metric indicates the number of times inventory is sold and replaced over a given period of time. This is usually calculated at the annual or seasonal level by dividing period sales by the average inventory value. Turnover isn't as effective an inventory method for calculating inventory needs for a short period of time as it is measured over a longer period of time. However, inventory turnover is a key metric that underlies the retail profit formula.

Basic Stock

Basic stock inventory planning involves establishing a baseline level of inventory for a given time period. This is a threshold that inventory levels should never fall below. It is calculated as average inventory divided by average sales. This method of planning inventory levels is useful for retailers with consistent-selling items that are not subject to large fluctuations. However, this is not a good method for planning seasonal categories or trend categories where sales are hard to predict. The Basic stock metric is an ideal inventory planning method for replenishment businesses at the SKU (Stock keeping unit) level.

Practice Questions

<https://assessments.lumenlearning.co...sessments/9260>

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