The Industrial Perspective

Controlling Inventory Liabilities for Diversified Industrials

Advisory

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To succeed in turbulent times, Diversified Industrials should seek to reduce inventory liabilities while still maintaining performance, quality and service. The first step is to gain detailed visibility into operations and processes based on proper metrics and analysis.

"Financially, today's economy has changed inventory from an asset to a liability; where inventory velocity is a key competitive driver on par with on time in full delivery."

Karl Overall, Director,
Business Performance Services,
KPMG in the U.S.

Inventory comprises raw materials, components, and finished products — the part of a company's assets destined for sale. A fast rate of inventory turnover results in a healthy revenue stream, which in turn satisfies the earnings expectations of stakeholders. Storage costs, obsolescence, and spoilage are the price that businesses pay for a high inventory kept over prolonged periods. Alternatively, too little inventory can result in missed opportunities and loss of market share. For companies to find the coveted 'optimal inventory level' may sometimes seem like the impossible dream of operational and financial management.

Visibility into working-capital issues

Inventory is typically addressed in the CFO's office where assets, liabilities, revenues, and expenses converge. The process that ties inventory into the financial controls of a company is working-capital management, one of the key components of return on invested capital (ROIC).

The three primary inventory issues impacting working capital are:

- How many inventory dollars are on hand?
- How long do inventory dollars sit on the books?
- Why?

CFOs can readily answer the first two questions. However, only answers to the third question — why? — can enable them to determine if inventory is an asset or a liability.

Unfortunately, many CFOs do not have the detailed visibility they need into operations and processes to properly identify and then mitigate inventory as a liability. Their financial planning and analysis (FP&A) reports only look at the effects of processes on inventory levels and time. As a result, CFOs take on faith that the right inventory drivers are being addressed to ensure that inventory is an asset rather than a liability.

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"There should be a balance between ROS and ROIC in today's companies to be competitive financially and operationally. The current economy has caught many companies overly focused on ROS with high levels of cash tied up in inventories."

Doug Gates
Principal, Business Performance Services,
KPMG in the U.S.

There are many perspectives as to how inventory can be viewed as both an asset and a liability, depending on who within the organization is looking. A sales manager's perspective may starkly contrast that of the plant manager because they are judged on different metrics. As such, we have laid out some perspectives below depending on the function within the organization as well as the profit measure being used.。

Inventory as an asset

Inventory can be considered as an asset that directly impacts return on sales (ROS) objectives. On-hand inventory protects against unplanned supply-and-demand variances. As inventory moves through operations, overhead is allocated to it and increases inventory value. Inventory is taxed as an asset and insured against loss much like buildings, property, and equipment.

Using the ROS metric, inventory is viewed as an enabling asset:

- In sales and distribution, having inventory on hand helps companies meet rapid order-to-delivery objectives, avoiding customer order delays and backorders.
- In manufacturing and engineering, inventory of raw materials and components is needed for production, supporting constraint utilization (making the most of system throughput capacity), and inventory availability for release ahead of need dates to support higher levels of utilization if needed.
- In purchasing, larger quantities can be used to drive down prices and improve product price variance (PPV) through economies of scale.
- In FP&A, inventory is a current asset and is accounted for accordingly.

Excess inventory as a liability

Inventory is a liability when considered in terms of the return on invested capital (ROIC). It has clear, adverse effects on many aspects of the business.

In sales and distribution, excess inventory increases the need for space, complicates first-in first-out inventory control processes, and delays shipping new product configurations to customers as older configurations on hand are cleared out. Having too much inventory also increases material handling requirements, impedes inventory-turn objectives, adds to product-obsolescence risks, and increases finished goods rework requirements if the goods are affected by quality defects or engineering changes.

In manufacturing and engineering, inventory affects key operational effectiveness metrics such as inventory turns and days-on-hand as well as work-in-process storage requirements, material handling requirements, and first-in first-out inventory control processes. High inventory levels affect engineering change implementation, and the period expenses go up if affected inventories become surplus or have to be reworked. If inventory is idle too long, product warranties can expire before products ship, increasing the risks of obsolescence and product liability to the company. Excess inventory can also mean that quality defects take longer to recognize, especially if defects are not found until many off-quality parts are consumed.

In purchasing, high on-hand inventory is counter to efficient inventory flow strategies. These strategies include just-in-time processes and kanban-based alerts that are triggered when inventory declines to a certain level.

We should also keep in mind that inventory has the same metric and operational-change effect in purchasing as it does in manufacturing and engineering.

In FP&A, inventory levels drive up days inventory outstanding (DIO). As DIO goes up, so does days working capital (DWC) as well as the company's cash conversion cycle (CCC). As more of the company's cash is held in working capital, profitability suffers because the money invested in inventory is idle, ROIC goes down, and the company is exposed to a multitude of revenue and period expense risks.

Excess inventory in companies typically results from forecast errors, inventory policies, planning practices, metrics in isolation, and product changes driven by anything from demand/supply volume, variety, and volatility to shelf life and storage methods.

Companies will always be faced with determining the right balance between ROS 'inventory is an asset' and ROIC 'inventory is a liability.' However, the current economy demands added scrutiny to reduce inventory excesses and better control over inventory liabilities.

Improving financial performance

KPMG member firms provide a wide range of services for industrial companies, helping them to address current issues and better position themselves for future growth. Our Diversified Industrials practice is backed by a knowledgeable team of specialists and deep experience across a broad range of disciplines, including:

- Contracts
- Business management
- Program scheduling
- Operations
- Supply chain
- Government regulatory and compliance.

In addition, our firms offer a tested, detailed, and structured process that has helped identify and remove significant levels of inventory that was a liability — often in a compressed time frame compared with what companies can typically achieve on their own.

To discover how inventory treated as an asset or a liability affects your company and what can be done to help improve resultant financial performance, contact one of the KPMG Industry specialists listed overleaf or your local KPMG representative.

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Contact us

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