

WHAT DOES IT COST TO CARRY INVENTORY?

IN this age of the "Profit Squeeze," it is becoming increasingly more difficult for management of wholesale-distributor firms to earn a reasonable profit—make an adequate return on invested capital—to compensate them for money invested in their businesses. The key role of inventory management in the profitability of wholesale distribution is too often overlooked. In the average wholesale-distributor business, **INVENTORY is the LARGEST SINGLE ASSET ITEM**, thus tying up a large portion of owner's investment.

Every wholesale-distributor business manager knows the **purchase price** of his inventory—he must also know **what it is worth**, for tax purposes. The question that is **too little understood and too often overlooked** in figuring the cost of operation of a distribution business is **WHAT DOES IT COST TO CARRY INVENTORY?**

Let's look at the total annual cost of carrying inventory as a percentage of the total value of the average inventory. For example, a firm's annual inventory carrying cost would be twenty-five percent (25%) if it cost the company \$50,000 in one year to carry \$200,000 of average inventory in stock. Does this appear high? Low? Unfortunately, not many wholesale-distributors know the answers to these questions. An examination of the literature on the subject reveals that some leading authors have made estimates of the total annual cost of carrying inventory, a summary of the opinions of which are shown in Exhibit #1.

Perhaps the most widely quoted estimate appears in Alford and Bangs' *PRODUCTION HANDBOOK* which sets the total annual carrying cost at twenty-five percent (25%) of the value of the average inventory on hand. The breakdown of the 25% figure is shown in the first column of Exhibit #2. The second column shows the estimate and breakdown of inventory carrying costs by Remington Rand in *INVENTORY CONTROL FOR WHOLESALE-SALERS*. Also shown, in the third column, is the combined estimate of seventeen wholesale-distributors in attendance at the "Third Planning for More Profits Seminar" presented by the National Association of Wholesalers in 1961.

Both the Remington Rand estimate and the combined estimate of the wholesale-distributor executives suggest that the **annual cost of carrying inventory** for an average wholesale-distributor firm amounts to **at least as much as twenty percent (20%)** of the average inventory value. This figure will, of course, vary between wholesale-distributor firms, especially the breakdown of the various cost elements, even though the firms may be distributing the same commodity lines.

The fact that actual carrying costs vary between wholesale-distributor firms, however, strengthens the need for each such firm to **determine its own inventory carrying cost figure**. These costs are **NOT REPORTED** in normal accounting records and must therefore be determined. **They are TOO IMPORTANT TO BE OVERLOOKED.**

Exhibit 1

ESTIMATES OF INVENTORY CARRYING COSTS		
Author	Publication	Estimate of Carrying Costs as a Percent of Inventory Value
L. P. Alford and John R. Bangs (Eds.)	PRODUCTION HANDBOOK (The Ronald Press Company, 1955) p. 397	25%
Dean S. Ammer	MATERIALS MANAGEMENT (Richard D. Irwin, Inc., 1962) p. 137	20-25%
John B. Holbrook	MANAGING THE MATERIALS FUNCTION (American Management Association, 1959) p. 67	24%
John F. Magee	"The Logistics of Distribution" HARVARD BUSINESS REVIEW, July-August 1960, p. 99	20-35%
Benjamin Melnitsky	MANAGEMENT OF INDUSTRIAL INVENTORY (Conover-Mast Publications, Inc., 1951) p. 115	25%
W. Evert Welch	SCIENTIFIC INVENTORY CONTROL (Management Publishing Corporation, 1956) p. 63	25%
Thomson M. Whitin	THE THEORY OF INVENTORY MANAGEMENT (Princeton University Press, 1957) p. 220	25%