Inventory is not an asset

BY CHARLIE BARNHART

Treat it as a liability, and inventory loses its allure.

Three accounting statements define the financial health of a business. These are the income statement, which identifies what was sold; the cash flow statement, which explains how cash came in and went out; and the balance sheet, which summarizes the resources used in running the business.

The balance sheet is composed of two parts: assets and liabilities. By accounting convention, inventory is listed on the assets side of the balance sheet. In practice, however, inventory is more like a liability than an asset.

This is true for five reasons:

- Inventory is purchased on credit, which uses up a company's liquidity.
- Inventory consumes administrative resources.
- It is perishable and decreases in value the longer it sits.
- It can only be profitably disposed of by transformation into products.
- Inventory reduces a company's ability to respond to the marketplace.

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How can this be?

First, consider that when an

uptick in demand occurs, even if you have every line item on hand to build the product, you'll be limited by the availability of short-term manufacturing capacity—unless you've mastered Lean manufacturing. (And if you have mastered Lean, you won't have inventory in the first place.)

Second, when a downtick occurs … well, that's too obvious. Just think back to how valuable your inventory was a few years ago.

Third, when the market goes dormant, as all complex systems do from time to time, it evolves. In business, a flat sales line is a potentially catastrophic event that signals the need for immediate action. Current products are updated, new products released and old products eliminated. None of it bodes well for inventory sitting on the shelf.

Finally, markets sometimes spontaneously revise their supply solutions. A case in point is Wal-Mart, which decided it didn't need OEMs to fulfill its low-end notebook requirements and started buying direct from original design manufacturers. Ouch!

So whether markets go up, down, sideways or off into some new supply territory, inventory slows a company's reaction time and makes it less nimble.

Inventory's ranking on the balance sheet, second only to cash and receivables, is also misleading. In accounting terms, the higher an asset is listed, the more liquid it's considered to be—so inventory's position seems outdated.

Current assets, from an operational perspective, are structured to offset current liabilities. But inventory takes a long time to convert to cash—and it remains a liability as long as it's outstanding.

So why is inventory still considered an asset? Maybe it's simply baggage we've carried with us from antiquity—a classification rooted in the days when folks went out "a-counting" how many sheep they had grazing in the fields. We'll never know.

What we do know, however, is that regardless of where it's listed on today's balance sheets, inventory is not—nor will it ever again be—an asset.

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