Retail Inventory Method 101: Principle, Applications And Calculator Included

Table Of Contents

Retailers use the retail inventory method is an accounting method used to estimate ending inventory balance for reselling purposes. This method is an approximation of the ending inventory derived from the cost of inventory relative to the cost of the merchandise. This is very popular with retailers since it saves the labor costs of frequent inventory counts. In this article, we are going to see the conceptual background of the retail inventory method, its formula, and the applications in this article. Read the blog for knowing more about the retail inventory method in detail:

Conceptual Understanding Of Retail Inventory Method

In simple words, the retail inventory method is the approximation of the costs constituting the retail price of goods available for sales. It uses the historical cost percentage markup of the inventory items to assign cost-to-retail price relationships. You should keep in mind the fact that this method relies on a consistent purchase price of the item you are dealing with. For instance, if you are selling Avocado face masks, their purchase price in the previous sales period and the current sales period should remain the same for getting more accurate results.

Stat Time: The retail sector in the US operates on an inventory accuracy of [63%](#).

The beginning inventory and new purchases are summed to get the total cost of goods available for sale. The total sales made in the given period are deducted from this figure, and the resultant amount is multiplied by the cost-to-retail ratio. Since there is no physical count of the inventory, you should periodically conduct manual counting to stay. This figure is used when a proper inventory management system is not utilized.

Example Of Applying Retail Inventory Method

Consider the case of the Avocado face mask:

- Cost price after paying for doing the branding work on a white-labeled product: $20
- Retail selling price: $35
- Cost to the retail ratio: 57%
- Beginning inventory for the sales period: $3,500
- New Purchases: $10,500
- Total sales for the period: $7,700
- Cost of goods available for sale: $14,000
- Ending inventory: $9,600

Thus, this method gives an approximation for the ending inventory without manually counting the particulars.

Market Fact: By reducing the stockouts and overstocking, you can slash the inventory costs by 10%.

The Limitations Of Retail Inventory Method (RIM)

The retail inventory method is widely used and is approved by the GAAP (Generally Accepted Accounting Principles), but there are a few limitations. I am listing down the disadvantages of RIM in the below section:

- The figures obtained through the retail inventory method cannot be used for generating financial statements.
- This method requires the cost price and selling price to remain constant between the subsequent sales period to stay valid.
- The need for physical inventory count cannot be completely removed.
- It does not take inventory shrinkage into consideration.

Retail Inventory Method Is Useful For Following Use Cases

In this section, I am sharing the feasibility of the Retail Inventory Method for various commercial organizations:

- Wholesalers dealing in large volumes of similar products with a consistent markup for all products being considered.
- Warehouses and storage facilities with slow inventory turnover ratios.
- Businesses with accurate demand forecasting and long term price negotiated deals.
- Firms with hedge contracts for the supplied materials and the sold items.

Summing Up

One reason behind this method's popularity is that many stores have a huge number of SKUs piled up despite a slow inventory turnover ratio. This is especially true for the godowns and HazMat warehouses where the markup (cost-to-retail ratio) does not change for a long period of time. Under such conditions, paying the workers for a physical count isn't a suitable option. However, it does not provide concrete data and is a bit better than making assumptions in the thin air. You should always continue making physical counts at a lower frequency to keep the accounting and management up to date. I hope you find this article insightful for understanding the retail inventory method.

Take a *free 14-day trial* of Orderhive!
