

Can You Profit From Improved Inventory Control?

Inventory control! If you're like most owners, that seems like a contradiction in terms. It doesn't have to though. You can control your inventory rather than the other way around.

What does inventory mean to you? Does it mean after-hours projects, such as extra paperwork or heated conversations with your bookkeeper over cost vs. markup vs. profitability? If you answered "yes," inventory probably also means "piles of money" on the shelf.

Inventory is money on the shelf. National averages for a typical mid size business \$10,000 to \$1,000,000 worth of inventory and 30 percent of that inventory is dead! A 21-month study conducted recently on what owners sell and what they stock, revealed that 11 percent of owners sell specialty items but don't stock them, while 18 percent stock specialty items, but don't have what they need.

What is the purpose of inventory? Many owners think it's there to facilitate shop operation by reducing rack time and increasing gross profit. In reality, however, inventory exists to improve your level of service. How? The right amount of the right part numbers will provide you with what you need when you need it, without enormous stress on your operating capital.

Consider the following two methods of inventory control.

Last In First Out (LIFO) means that when there is more than one of a given part number, you sell the last one received, first. The rationale being that the newest is probably the most expensive. First In First Out (FIFO) means that when there is more than one of a given part number, you sell the one you've had the longest, first. The rationale? To keep your stock rotating. Whether you use LIFO or FIFO, the actual transfers are only taking place on paper. The old dusty part may be pulled off the shelf, but it's the new expensive one that's reduced from inventory. Ask your bookkeeper which is the correct method for your business.

Why should you even consider these inventory control methods

listed above? Take a moment to compare the value of your inventory to the value of some piece of your equipment. When you purchased the expensive piece of equipment, you probably considered various things. You probably shopped for the best price and considered return on investment. If the equipment wouldn't pay for itself, you probably would not have purchased it. After the purchase, you monitored your investment to maximize its use and, therefore, its return.

All the same rules apply to your inventory investment. There are some fundamental differences, however, between your inventory investment and your capital investments. Your equipment is depreciable, while your inventory is taxable. Your capital investments happen suddenly, while your inventory value creeps up gradually. At some point, most shop owners end up with a large inventory investment on which they pay taxes, yet rarely do they monitor or control it properly. Face it, it's a time-consuming process in an industry that holds time at such a premium that you charge for it in six-minute increments.

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So what to do? Some think the best inventory is none at all. Inventory interferes with your productivity. How much time do you spend counting it, ordering and receiving it, tracking incorrect orders, stocking shelves and tracking returns? How much energy goes into protecting it? How often do you give something away?

Inventory Calculations

When was the last time your parts percentage figures were at the level you require for profitability? There are two calculations that are often overlooked when determining inventory profitability. The first is cost-to-order, the second is cost-to-keep. The factors involved in cost-to-order are time and money. Time to calculate order quantities and time to do paperwork, time to receive it, stock it, correct errors and then time to track them, and money to pay someone to do it all. To determine your cost-to-order, you first must learn how much:

- time is actually spent deciding what to order;
- time it takes to do the paperwork;
- time it takes to check in and stock the order;
- you pay the individual(s) that actually perform each step.

If the inventory value of the order received is \$100, and if you sell parts at a 45 percent margin, you'd sell that \$100 for \$182. The formula here is: selling price = cost of goods (in this case, \$100) divided by the result of 1.00 minus the margin (.45 in this example). If your cost-to-order is \$10, what happens to the selling price? If it remains the same, you just lost money. (The cost of goods remains at \$100, but the cost to order = \$10. A \$110 investment would gross \$200.20 on a 45 percent margin). You just lost \$18.20.

There is also a calculation called cost-to-keep. Space does not permit a lengthy discussion, but the important point to consider is how much it costs to buy inventory based on how long you own it, as well as how much return on investment you could get on that dollar if it wasn't on the shelf. You must also factor in cost-of-obsolescence. For example, if it costs you 10 percent to keep something on the shelf, and you receive a 5 percent quantity discount, maybe you shouldn't buy it. The lowest price is not always the best price.

If gaining control of your inventory sounds like the impossible dream, it's not. My recommendation is to look into just-in-time inventory. This means that you order on a regular basis and purchase only when you need to replenish what has been sold since the last order. Just-in-time inventory means you must have short inventory order cycles and accurate tracking to determine what and how much inventory to stock. It is an attainable goal.

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Seven Steps To Improve Inventory Control

The following seven steps can help you improve your inventory control, improve your level of service and improve your bottom line.

Step One

Determine which items are your real movers. To accomplish this, you must first determine what represents “dead” inventory in your store. Be realistic. Don’t forget about that shelf of dealer parts tucked away in the back. A good way to measure dead inventory is to evaluate inventory turns. Turns equal cost of goods sold (COGS) divided by inventory value. Calculate COGS on your inventory as a whole, then recalculate on specific lines such as belts or hoses. You may be surprised by the result. Your computer system should be able to provide accurate purchase data by line. If not, speak with your bookkeeper about supplying the proper information.

Step Two

Turn dust into dollars. You must get rid of what’s not moving. If you multiply your gross profit percent by what you can recover by turning it in, for example, 50 cents on the dollar, 30 cents on the dollar, etc., you’ll arrive at the amount of reinvestment capital available to you. It’s important that you don’t get trapped by thinking about what you paid for it vs. what you can get for it now. Inventory turns can be increased by either selling more parts, or by reducing inventory value. If inventory turns increase, so does your bottom line, guaranteed.

Step Three

Analyze your business profile. It’s important to consider what you have in stock vs. what types of repairs you perform. Do you do lots of brake repairs? Stock lots of brake parts? Do you ever have to order parts when doing a brake repair? How is the level of your service affected by having brake parts in inventory? Is it working? If not, why stock it?

Step Four

Determine what and how much to stock. Who makes the ordering decisions in your shop? Does he/she consider seasonal items? Do you utilize replenishment ordering, or do you order to stock levels? If you use the latter, who determines the stock levels? Determining what to stock (and how much) is similar to determining your dead inventory. The difference is how much inventory do you really need? Again, your computer should be able to tell you what is selling and which items produce the greatest gross profits. If the gross profit percent is low on a given item, sales have to be high. But, if gross profit percent is high, you can get away with selling fewer of that item. Remember the goal you want to maximize your level of service. If stocking an item doesn’t help you reach that goal, don’t stock it.

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Step Five

Monitor sales for profitability. It's easy to fall into the we-sell-lotsa-em, we-better-stock-lotsa-"em" trap. It's a trap because high sales volume doesn't necessarily equate to high profitability. If you're losing money each time you sell one, you can't make it up in volume. A better consideration would be to determine where the profit lies and unload everything that isn't profitable. Gross profit per line item is one measure. How much it costs to wait for parts is another. Most of this information is available from your computer (or your bookkeeper from information you're already providing him/her). Remember, a 1 percent increase in gross profit equals a 1 percent increase in net profit, if the volume remains constant.

Step Six

Establish daily ordering. This step is nearly self-explanatory. Once you've determined what the movers are, gotten rid of the dead inventory, and determined what and how much to stock based on the types of repairs you perform (and the profitability), then you're ready to order and receive parts daily to replenish yesterday's sales. If you're automated, it won't be a problem. If not, it's still doable.

Step Seven

Buy smart. When selecting a supplier, realize that prices are so competitive and deliveries are so good that you do have choices. It's important to evaluate what you can get from your supplier other than parts. For example, will your suppliers analyze your purchases and returns on an item level? What are your return privileges? What percent can be sent back "no questions asked"? Will they clean up your inventory? How often? Many of these important issues are overlooked when choosing a supplier.

Five Rules To Live By

Here are five rules to live by while operating your business. Post them prominently in your office next to your phone. They, too, will help you improve your bottom line.

- Don't stock anything you can have delivered in a reasonably short timeframe.
- Never promise delivery in less time as your production or delivery schedule allows.
- Never buy anything that can't be returned (unless the customer pays up front).
- Do a physical inventory at least once a year. Return anything that's allowed.
- Compute margins and turns.

There are dangers in trying to stay caught up with parts proliferation. That job belongs to the jobber, not you. Your job is to monitor your inventory and make smart choices. With the "hot shot" delivery capabilities available nationwide these days, there's no need to stock anything that doesn't sell quickly and for the right profit percentage.

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