

Is Storage Costing You?

The items you keep in your stock inventory could be decreasing your profitability. To prevent this, develop an approved stock list and determine the profitability of specific items and product lines.

By Jon Schreibfeder



Bulky items such as containers can take a lot of storage space.

When you stock a product, you are making a commitment to have that product available in reasonable quantities for immediate delivery to customers. Retailers need to keep items in stock to stay in business, even if it means having to store bulky containers and statuary. But that stock could be decreasing your profitability.

The first step toward increasing the productivity and profitability of your investment in stock inventory is developing an approved stock list and determining the profitability of specific items and product lines.

Most distributors' and retailers' facilities are filled with two things: stock and stuff. Stock is the material you intend to have in the warehouse — stuff is everything else. Stuff includes dead stock, leftover quantities of special-order items, unwanted returns, etc. It may also include some slow-moving products. The first task is to separate the good "stock" merchandise from the "stuff." This is the process of developing and maintaining an approved stock list for each branch, store or warehouse.

Track Product Sales

The more frequently customers request a product, the more reason you have to stock it. A "hit" represents the appearance of a product as a line item on a customer order, regardless of the actual quantity ordered. If your computer system records the hits for each product, sort your inventory based on the number of hits recorded in the past 12 months. Does each of the items that sold only once or twice in the past year need to be retained as a stock item?

Create a spreadsheet. If your computer system does not maintain the number of hits by product, there is an alternative. You can probably examine the number of months with product activity. To do this, download the item number, description and 12-month usage history into a spreadsheet similar to Figure 1, below.

If you are using an Excel spreadsheet, the command "countif" can be used to determine how many products in the past 12 months had usage activity; other spreadsheets have similar commands or functions. The goal is to count how many of the cells between columns C and N have a value greater than zero. The results are shown in column O.

Analyze the results. Item A100 had sales in two non-consecutive months in the past 12 months. Could this item be special ordered when customers require it? Could the customer be sold a similar product in place of this one? On the other hand, item B200 was sold in each of the past 12 months. This item should definitely be retained in stock inventory.

Many distributors find that a large percentage of their inventory is requested less than three times a year or sold in less than three months! I am not suggesting you automatically discontinue all of these items; just be sure you have a good reason for keeping them in stock.

The overall analysis will divide your inventory into three categories:

The Good: This is stocked inventory that provides a positive return on investment.

The Bad: Bad inventory doesn't provide a return on your investment but contributes to other profitable sales; it is an expense of doing business. For example, a line of slow moving repair parts to support the sales of other, profitable products.

The Ugly: Inventory that doesn't provide a return on your investment or contribute to profitable sales.

Defining Profitability

How does the typical retailer define profitability? If you ask someone in the sales department, you'll probably hear about gross margin.

$$\text{Gross Margin} = \frac{\text{Annual Sales Dollars} - \text{Annual Cost of Goods Sold (CGS)}}{\text{Annual Sales Dollars}}$$

Under most circumstances, salespeople would rather sell a product with a

Product Activity Spreadsheet															
	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
1	Item	Desc	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Mo w/Sls
2	A100	A100QC Fit	2,000	0	0	0	0	0	2,000	0	0	0	0	0	2
3	B200	B200QC Fit	20	10	15	6	8	26	30	14	19	20	12	18	12

Figure 1: Create a spreadsheet like this one to examine the number of months with product activity. Include the item number, description and 12-month usage history in your spreadsheet. The goal is to count how many of the cells between columns C and N have a value greater than zero. The results are shown in column O.

24-percent margin than an item with a 20-percent margin. Why? Because many salespeople are paid on gross margin. But does the company get a better return on higher-margin products? It depends on the average value of inventory the company must maintain to generate the sale.

The average inventory investment depends on many factors:

- Cost of the item.
- Variations in customer demand.
- Reliability of the vendor and method of transport.
- Quantities that must be purchased to sell the item at a competitive price.

Often, retailers have to carry a relatively large quantity of low-hit products, which means there may be a lot of money tied up in inventory, and the higher the investment, the more it costs to maintain the inventory in a warehouse.

There are many expenses included in carrying inventory:

- The cost of putting away and moving stock.
- Rent and utilities for the stock area of the warehouse.
- Insurance and taxes on inventory.
- Inventory shrinkage and obsolescence.
- Lost-opportunity cost of the money invested in inventory.

Calculate Actual Cost

Typically, the carrying cost of inventory is 17-25 percent per year of the average inventory value. That means it costs between \$.17 and \$.25 to maintain a dollar's worth of inventory in a warehouse for an entire year.

So does a product with a gross margin of 24 percent always contribute more to a company's bottom line than another product with a lower gross margin? To determine this, you have to examine more than just gross margin. If you subtract the yearly cost of maintaining the inventory from the annual profit dollars, the result is a new measure of profitability, the adjusted margin.

$$\text{Adjusted Margin} = \frac{\text{Annual Sales \$} - \text{CGS} - (\text{Inventory Value} \times \text{Carrying Cost \%})}{\text{Annual Sales \$}}$$

Look at the adjusted margin of two products:

Product A

- Annual Sales = \$12,500
- Cost Of Goods Sold = \$ 9,500
- Average Inventory Value = \$5,000
- Carrying Cost Percent = 25 percent
- Gross Margin = 24 percent
- Adjusted Margin = $\frac{\$12,500 - \$9,500 - (\$5,000 \times .25)}{\$12,500} = 14 \text{ percent}$

Product B

- Annual Sales = \$12,500
- Cost Of Goods Sold = \$10,000
- Average Inventory Value = \$2,500
- Carrying Cost Percent = 25 percent
- Gross Margin = 20 percent
- Adjusted Margin = $\frac{\$12,500 - \$10,000 - (\$2,500 \times .25)}{\$12,500} = 15 \text{ percent}$

Even though Product B has a lower gross margin, its adjusted margin shows that it contributes more to the company's profitability.

Get started on developing an approved stock list for your store. It is the first step toward achieving the goal of effective inventory management. To help determine your company's specific inventory carrying cost, see the article *The Mysterious Cost of Carrying Inventory* available at www.effectiveinventory.com for a questionnaire to calculate your annual inventory carrying cost. 📄

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