Visions Tip: How to Make More With Less

Metrics That Provide Clear, Concise Inventory Performance and Profitability Over Time

Since 1985, we have worked with many, many distributors, selling many different type of products. Even though their locations and industries are different, we have found the solutions to their problems to be very similar. The internet, tough economy, lower margins and tough competition are making it difficult to stay in business and is forcing owners to change their thinking on how to best run their operation.

Following are 4 tips on the first steps to strategically gain control with Inventory Metrics.

1 **Customer Service Report:** This measures the percentage of time that you have stock available when a customer wants it. We are starting with this metric because it is the most important. If you don't have what they want, they may start going to another supplier.

The formula is simple; you take the number of line items shipped complete (not backordered or lost) and divide by the total number of line items ordered. If the order is lost, your customer will probably go to your competitor down the street. If the order is backordered, you will have increased cost of processing an extra receipt and your warehouse will incur the cost of picking and filling two orders. Backorders can be very expensive if you have trucks that deliver your orders.

Use only stocking items in your calculation. Do not include Special Ordered Items or Direct Shipments to your customers.

The goal of this metric is to have your percentage at 95% or higher. Your report should print only the line items that were backorders or lost with the Customer Service percentage at the bottom. It is impractical to have 100% because there are always a few orders with unusually high quantities of stock items that will cause a back order or lost sale.

Be sure to examine each line that was not shipped complete. If the items stockouts are high and it is in the top 10% of the Hits Report, then your buyers are not ordering enough. If you are out of stock for a prolonged time, then your buyers need to improve the source of supply for this item.

2 **Inventory Turnover:** The inventory turnover metric (a/k/a "turns") gives us the number of times that we are turning our inventory investment into "profit opportunities". It is a measure of the number of times inventory is sold or used in a time period, such as a year.

$$\text{Inventory Turnover} = \frac{\text{Cost of Good Sold}}{\text{Average Inventory}}$$

Average cost is usually used but a last price paid or standard cost can be used. The important issue is that you should be consistent in the formula. The Average inventory is received by:

$$\text{Average Inventory} = \frac{\text{Beginning + Ending Inventory}}{2}$$

Do not include Special Ordered Items or Direct Shipments to your customers.

The inventory turnover ratio is used to measure the inventory management efficiency of a business. In general, a higher value indicates better performance and lower value means inefficiency in controlling inventory levels. A lower inventory turnover ratio may be an indication of overstocking which may pose risk of obsolescence and increased inventory holding costs. However, a very high turnover may result in loss of sales due to inventory shortage. Inventory turnover is different for different industries. Businesses which trade in perishable goods have very higher turnover with comparison to those dealing in durables. A comparison would be fair only if made between distributors of same industry.

Should you always maximize your inventory turns to maximize profit? It depends ... to find out, we need to look at the Turn-Earn metric.

3 Find your winners and losers: Getting a handle on inventory is essential to profitable operation. But as every distributor knows, it's tough to strike the right balance between too much and too little.

Distributors typically strive for getting very high turnovers on their inventory. Fast-selling products seem worthy of a dominant role but sometimes slower-moving products can be just as profitable if their margin is high. An analytic technique known as "turn and earn" can be a powerful tool to help sort winners from losers so you can fill you warehouse with winners.

Turn-Earn Metric = Gross Margin x Turnover

If you have a distributor with a 30% Gross Margin and 6 inventory turns, that gives a Turn-Earn Metric of 300.

If a distributor has a 20% Gross Margin, it then takes 15 inventory turns to achieve the same Turn-Earn metric of 300.

Most distributors try to target a Turn-Earn metric of 120 or greater. This means if they achieve a 30% Gross Margin, they need to turn their inventory 4 times. If they have a 40% Gross Margin, then they will need to achieve 3 turns for a Turn-Earn metric of 120.

Your computer software should also be able to run this report by category or product line. Calculated across the entire product line, the Turn-Earn report reveals your top and bottom performers. For accurate analysis, the index must be calculated across a product line, rather than for a single item. In addition to providing product comparisons, Turn-Earn metrics can help pinpoint operational problems.

You should also be able to break the data into other groupings, such as individual purchasing agents or separate warehouses. This may offer insights into internal factors involved in performance variations. Generally, product line Turn-Earn scores should be around 100 or higher, and usually the higher, the better. But sometimes a very high rate may reflect problems. You might not be carrying enough stock to meet demand, or your margin may be so high that you are leaving yourself open to opportunistic price-cutting competition. The logic is straightforward: When competition keeps margins low, the inventory must turn faster. If margins are high, however, a slower turn is acceptable. Calculate turn and earn at least quarterly, to keep operations abreast of changes in demand, competition, and profitability.

4 GMROI: This metric stands for Gross Margin Return On Inventory Investment. This dynamic measure of inventory productivity expresses the relationship between your total sales, the gross profit margin you earn on those sales, and the dollars that you invest in inventory.

$$\text{GMROI} = \frac{\text{Gross Margin}}{\text{Average Inventory}}$$

The beauty of the GMROI calculation is that it works for any size store, and for any department or product line or category within your company. Your software can get GMROI reports automatically as part of your monthly accounting reports. Use them! Compare Productivity of Merchandise Categories. Or Vendors!

By calculating GMROI for every merchandise category in your store, you can rank each category according to its rate of return. Some distributors also rank their vendors by GMROI, and let the vendors know where they are on the list. This adds more objectivity to your discussions with vendors.

There are hundreds of metrics that are available to measure your inventory. However, the Customer Service, Turnover, Turn-Earn and GMROI provide clear, concise and current analysis of the distributor's large, critical investment.

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