

Do The Math!



The Inventory Trap

By Jay Goltz

Can't find where your profit went? It may be just sitting there in your inventory.

Profit is not the whole picture. Here's a little accounting riddle to see if you really understand accounting and why profit doesn't tell the whole story. Let's say you've had a really busy year. You've kept good records of all your financial details. Your account receivables are up to date. As a matter of fact, they are about the same amount as they were last year. You haven't paid down any debt. Your financial statements show you have a very healthy profit. So healthy, in fact, that you decided to buy a new house or a new car. Or maybe pay off some debt.

You go to the checkbook to pull that extra \$30,000 out of the business and, lo and behold, the cupboard is bare. You have no money. How can that be? Theft? Perhaps, but probably not. You bought a bunch of new equipment? In this case, you didn't. What's the most likely culprit? Inventory.

In the heat of the moment when you are busy it's very easy to over-order inventory. Sometimes it's because you get a better price or because deliveries are unreliable. Sometimes it's because you thought you were out when you really weren't. In some cases, a large customer stopped ordering a particular item after you had already ordered the inventory. I have experienced all four of these problems.

Let's look at the two options: You don't have enough inventory. As a result, a customer's order is delayed. You may not have enough other work for your people to do, and you have to send them home. You put stress on your suppliers to ship quickly and maybe pay extra shipping costs. Then, when the moulding comes in, everyone has to put in some overtime.

Compare that to the other alternative. You bought too much moulding. None of those other things hap-

pen. Everyone is calm, cool, and collected. The orders go out on time, and everyone's happy—for a while. Until all of a sudden you don't have any money. You're concerned. You take a thorough inventory. You find out that all of your profits are trapped in your inventory. You feel better, but you still don't have any money.

Or think about this scenario. It's not you who does the ordering; it's one of your employees. That person has to deal with you when a customer calls in mad. There's not enough inventory for a project, and your employee feels the stress. What do you think is going to happen next time? That employee will over-order to make sure that your company never runs out. And, in the end, you'll have too much inventory.

So now you have to go about getting rid of your excess inventory. If you're lucky, you just have too much of a staple item that will work itself out over the next month or two. On the other hand, if your customer changes moulding that you had just stocked up on, you could be stuck with that moulding for many months or years.

What's the solution? Controls. On big orders, this means making sure your calculations for scrap loss are accurate and that you match purchase orders from your customers to purchase orders to your vendors. It's also critical that whoever is in charge of your inventory has a good handle on what's there. It sounds simple, but it's not. The point is, your income statement only tells part of the story. You can be very profitable and not be able to pay your bills because your cash is in inventory.

Having out-of-control inventory has seriously damaged many companies and even put some out of business. Something that can take 10 seconds to order can take 10 years to get rid of. I know; I'm in year seven. Anyone interested in buying 59"x80" clear plastic bags? No, really... ■

Let's do the math:

	REGULAR	SPECIAL
Moulding Bought	3,000' @ \$2	6000' @ \$1.50
Cash Outlay	\$6,000	\$9,000
Cash left in Inventory	\$0	\$4,500
Savings	\$0	\$3,000
Net Cash	\$0	(\$1,500)

If you need 3,000 feet of moulding for a job but opt for a lower price at a larger quantity, you can save money—but end up with your profits tied up in inventory.