

Financial Finesse Series A Question of Balance in Inventory

Every woman knows that in business, as in life, success is all about balance: balancing the professional with the personal, the family with the work, the fun with the not-so-fun. In any company, there are unique challenges to maintaining balance. In the case of enterprises that produce and/or sell product, a tell-tale sign of effective management is the owner's ability to match product-on-hand with customer demand. There exists a critical tipping point between costs associated with carrying inventory, and the revenue that results from their sale. Ideally, the two are so closely aligned that costs are immediately and generously offset by revenue.

Good market research

Of course, we don't live in a perfect world and you are not privy to perfect information. Experience helps, so balancing stock with customer demand can be especially hard when you are first starting out. Good market research is key as is, some would argue, a gut-feel for the industry you're entering. If you open your doors with an understanding of what your customers want, how often they are going to want it and what they are willing to pay for it, you're ahead of the game.

Fortunately, the game becomes a little easier once you've been in business for a while. With some sales under your belt, and a history of customer behavior to guide you, you have a lot more solid foundation on which to base buying or production decisions. Take the case of Cathy Burrell, who owned and operated Cavern Clothing, a women's clothing store in White Rock, for almost twenty years.

"I had a buying plan at the beginning of each season," says Cathy, "based on my sales for the previous season. I worked one year in advance. I would plan to buy twice a year, looking at my sales from the year before and deciding from there how much I wanted to invest per clothing category."

"I had a computer system that broke down the merchandise I carried into seven different categories. I would recommend using a computer system to anyone in retail. Get weekly and monthly reports. As long as your system can give you information on what you've purchased and your sales, it's a massively important investment. When you're in retail clothing especially, cold hard numbers are what you have to rely on."

"In my business, I tracked how much I sold in each stock category and I decided, for each one, how much I wanted to sell for the next season. It's a numbers game when it comes to how much sales to anticipate. Sell too much compared to what you purchased and you are understocked; not enough, overstocked. Sometimes, you really have to commit to a product or take the chance that you're going to be stuck with stock. Of course, if you have too much stock you can always reduce it a bit and put it on sale, but if you don't have it, you're in trouble. You can't sell a lost customer."

Two key ways in which inventory management can go wrong

The first occurs when customer demand is overestimated and you find yourself with a surplus of stock. Some of the common contributors to overestimating demand are:

- relying on subjective information. Your own preferences, an inflated sense of confidence or even comments from family and friends can cloud your judgement;
- assuming a customer buying trend that doesn't exist. You see a product take off suddenly and figure it's a sign of things to come. In fact, it's a blip on the radar;
- relying on one or two major customers for your sales. There's so much to do when you're a small business owner that if a large account steps up to the plate, it's hard not to give them all your attention. If that customer then goes out of business, moves, or finds a new supplier, you're left holding the bag. Carrying substantial inventory to meet the needs of a single customer puts you at tremendous risk. It's worth asking yourself whether your pricing reflects that risk and the carrying costs you are incurring.

While it's true that you can often sell overstocked items at a discounted price, this is never a preferred option. Discounting cuts deeply into or even erases your profit margin - the money you need to support operations. On the other hand, old inventory represents cash you could be using for other things like paying bills, advertising or staff. Only you can decide the relative costs of selling it now at a discount versus keeping it on the shelf a bit longer. There's a tradeoff to be made. If you choose discounting, your short-term cash flow may well experience some relief. Be sure, though, that you've made allowances for discounting in your cash flow forecasts so you're not counting on bigger margins than you are able to achieve.

The second major cause of poor stocking decisions is rooted in fear: fear of borrowing, fear of spending, fear of failure. Specifically, not carrying enough inventory stems from such things as:

- underfinancing. You might be a little nervous about fully committing to your business and its success. You dabble, 'test the waters' so to speak, until you see how things go. Such a conservative strategy can work, but take care that your business doesn't take off without you. You'll need to be cash-ready to build up inventory should the market tell you it's time;
- underestimating operating costs. These are the costs associated with overhead and if they are eating up a lot of the money you have to work with, there won't be much left over for purchasing or producing stock;
- underestimating customer demand. Without good market research or a history of sales to go on, it can be easy for the conservative among us to fall far short in estimating customer need and demand;
- allowing a single big order to deplete your stock. This is sort of the flip side of losing a key account. In this case, you take on a big customer and have insufficient product to meet the demands of both this customer and the others who rely on you. Something's gotta give and it's likely to be the confidence of loyal, bread-and-butter buyers in your ability to meet their needs.

Know your customers and suppliers

As with most things in business, good inventory control comes from knowing your market and finding smart, efficient ways to serve it. Susan Gagnon of SYKA® Textiles Trading Corp., a fabric importer and wholesaler specializing in eco-fabrics, has learned to do this very well.

“With inventory control one of the things we find helpful is that maintaining close contact with our designers (customers) allows us to plan from our side to meet their needs,” says Susan. It’s crucial that we have fabric available when they need it. If you get large orders out of the blue, it can create a few challenges with inventory.”

“Our connection with our suppliers is the other half of the equation. We have solid suppliers and keep in close contact with them. The supply chain is everything and we have learned that sourcing a good product takes an enormous amount of time and resources. You must find and then build relationships with solid suppliers who you can trust to consistently deliver a great product on time. This takes years.”

“We keep track of our inventory through computer systems for inventory management. We have a many different fabrics in different colours, so there is plenty of product to monitor. While there are lots to keep track of, we love stocking fabric; it makes our customers’ lives much easier in that they have no minimums, minute lead times and a tonne of flexibility. In that sense, we work differently that most mills and wholesalers. Stocking inventory does present some challenges but for these reasons, it’s definitely worth it.”

Inventory Turnover

Once you have some sales under your belt, you can begin to take a methodical approach to assessing inventory turnover. It is best to look at how fast your product is moving either by individual item if you only sell a few, or by category if you sell many. The time frame in which to measure can be as short as a week or as long as a year. Generally speaking, a month is a good time frame to consider - long enough to show emerging trends, and short enough that your stock can’t get too far out of control before you take action.

The formula for measuring inventory turnover is:

$$\frac{\text{Cost of Goods Sold (that is, your cost of product sold for the period)}}{\text{[divided by] Average Inventory for the period}}$$

Average inventory is measured the adding together the value of your beginning inventory for the period and your ending inventory for the period and dividing it by 2.

Generally, you would expect bigger ticket items to turn more slowly than lower-priced items. It’s sad, in a way, because high-priced products are often the ones that tie up your money as they sit in inventory. Your job is to decide how quickly items should turn, whether they pull their weight relative to the cost of keeping them in stock and when it might be time to fire-sale them out the door. The last thing you want is to be caught holding old, out-of-date or even expired product that nobody wants.

High product turnover is usually a good thing. It shows that stock is moving in and out of your business as it should. If the rate is too high, however, or you're running out of stock, it might be time to increase your inventory levels in order to meet customers demand. Even loyal customers will become disillusioned with you if the products they rely on you for aren't there.

Again, it's all a question of balance.

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