Retailer’s Profitability Cookbook©

By James D. Payne, CPA

My favorite ingredients and menus for improving retail profits.

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About the Author

Jim Payne is a Florida CPA with over 30 years of experience in the business world. He graduated from Florida State University in 1973 with a Bachelor of Science Degree after majoring in Accounting. He has held various positions to include:

- IRS Agent.
- Controller of Central American operations for a major highway constructor.
- Owner/operator of a CPA firm offering tax and accounting services for over 15 years in Tampa, Florida.
- CFO of a multi-state retailer.
- Consultant/Software Developer since 1999.

After selling his CPA firm, he went to work for a multi-state retailer as the CFO where he learned first hand the problems facing a growth business. He spent several years learning the art of software development to complement his accounting skills. Web-based software is the biggest tool in the toolbox used to continually improve business processes.

Jim currently resides in Gainesville, Florida with his wife Pam. He is an accomplished instrument rated private pilot with over 1500 hours of flight time and ardent supporter of the Fair Tax proposal currently before Congress.

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Introduction

My goal with this book is to build a list of suggested strategies and tactics to deal with items that affect the profitability of small retail chains. All of these recipes have been compiled from various sources. My requirement for including them in this manual is that they must be practicable for my clients at the level of business that they are involved with. Any suggestions or ideas for additional inclusions are appreciated.

This book is a continual work-in-process. I add to it whenever I come across a new idea that could have an application in the retail environment.

What this book is not about.

This book is about improving your profitability through better operations rather than sales and marketing. Providing advice on the best strategy for marketing channels or what your ad needs to say to get the best pop for your buck is best left to others. I have opinions on the subject, but no scientific information regarding what works or does not work to back it up.

Who will benefit from this book?

I like to work with small retail chains that are struggling to move their management systems up to the next level; typically, companies with less than 100 locations and sales between $10 and $100 million dollars. Management in these situations is trying to build its infrastructure resulting in overhead costs rising faster than sales. Building these processes is a challenge since most owner/managers have little or no formal training to guide them through this stage of their business's life.

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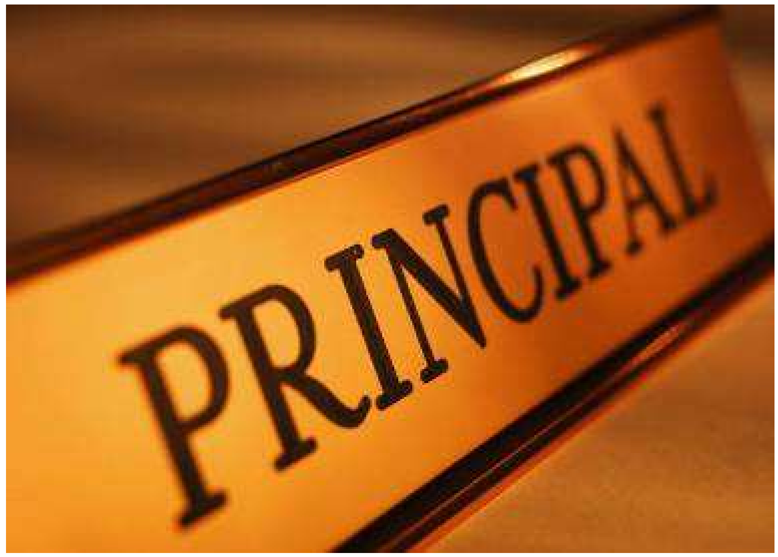
1 Profitability Principals

Principals are fundamental rules that almost always apply. These profitability principals almost always work in the application of any of the ideas or formulas in this book.



1.1 *Principal 1 – It's the process that makes it work in the long-term.*

This principal took me the longest to learn. Let's say you decide that you want to reduce your inventory levels. You could achieve this by requiring that all purchase orders be approved by you. Then you could then reduce the quantities ordered for products that are being over ordered. Inventory levels will begin to drop.

However, this will only work until such time that you get busy with other projects and begin to loose interest. The POs start to backup and you start rubber stamping them to eliminate the backlog. Eventually, the inventory levels slip back to their previous levels. To permanently lower the inventory levels you have to make some change in the business process so that the system will produce the results you need each time, without the necessity of supervisory intervention.

1.2 *Principal 2 – In order for any profitability formula to succeed at increasing your net profits, you must make sure that it does not conflict with your primary strategy.*

You can't be all things to all people and businesses are no different. Adopting a strategy of being extraordinarily good at all things produces a business that is mediocre at best with nothing to differentiate them from their competitors.

Successful retailers have, by design or happenstance, become very good at one or two things and at least adequate at all other things. That "One Thing", be it speedy delivery or depth of product offerings, is not to be trifled with lightly.

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Make sure that any changes to your business processes do not impede your excellence at that "One Thing" or you might end up with a net loss due to lower sales.

1.3 *Principal 3 – Profits and Cash Flow are usually not the same.*

Cash either leads or lags profits. An increase in your accounts receivable balance means that while sales may be up, the cash has yet to come in. Conversely, you could be loosing money and not realize it due to strong cash flow produced by lowering accounts receivable and inventory balances.

It's not all that hard to temporarily produce positive cash flow while suffering a loss of profits. A new loan will do it. However, the only way to produce long-term positive cash flow is to produce profits. You can't borrow your way to prosperity so concentrate your management time on producing profits rather than cash.

There are two exceptions to this principal:
Accounts receivable and more importantly inventory levels must get their fair share of your time. Failure to keep your A/R current and your inventory levels low will result in losses due to write-offs. Many times these losses are not discovered until year-end when it is too late to do anything about it.
If a business that is in danger of collapsing then the only thing that counts is cash flow, not profits. This strategy only buys time for a new plan to work. With a new plan, maybe you can save it. Without a new plan there is no chance for success. In my experience, you are better off minimizing the loss to the owner by giving it up and moving on with your life.

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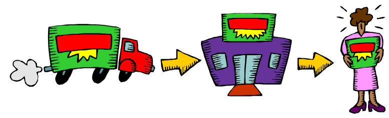
2 Business Processes

2.1 *Benefits of Managing Business Processes*



If there is one lesson I wish I had learned early in my career, it's the results you can get by improving your business processes. Business process improvement is a mundane and unexciting subject that requires a lot of detail work and concentration. Moreover, it is a job that is never completely done. There is no big moment of recognition like you would get with the release of financials showing a great quarter or the timely completion of a big project. Instead, maybe, just maybe, someone will one day come to the realization that your division just works well regardless of the crisis of the moment.

The benefits to the owner of a business that is well run are boils down to two categories:

- Higher than average profitability, and perhaps even more importantly,
- Far less fire fighting.

Additionally, there is flexibility in a business with good processes. If you ever have to evaluate two businesses, one with an excellent strategy and poor business processes and the other with a poor strategy but the ability to produce, always pick the one with good processes. It is a lot easier to change a poor strategy to a good one than it is to change a non-productive business to a productive one.

2.2 *Identifying your Business Processes*

A process is any set of repetitive steps by definition. The important thing is to have process starting and ending place that makes sense for your size of business. Every small retail chain will have these processes that make them money:

<u>Purchasing process</u> – starts with a decision by the store manager to replenish the inventory and ends with the receipt of goods by the store and payment of the vendor's invoice by the accounting department.

<u>Sales process</u> – starts when a potential customer hits the door and ends with their commitment to buy.

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Delivery process – starts with the customer commitment and ends with the customer's receipt of goods and the payment in the bank including all the necessary accounting.

Additionally, there is any number of other processes that your business may or may not have such as:

- Payroll process
- Media buying process
- Store cleaning process
- RGA process

2.3 *Business Process Strategy*

Trying to be great all things is a guaranteed looser. Instead your business needs to be truly great at something that appeals to your customers and adequate at all others. Once you have identified what it is that you are or hope to be great at, you should identify all those business process that support the "Great Thing".

Let's say for example that your great thing is superior delivery. You get it there on time, every time, with all the right stuff and that is why your customers prize you over your competitors. Obviously, your delivery systems must be superb. Additionally, all the systems that support the delivery systems must also be above average. Your inventory systems, for example, need to provide the goods for delivery on time, every time. However, your customers won't go away just because your billing system isn't the world's greatest. If that were the case, they would have already left you for the competitor that did the superior job of billing and who probably wasn't that good at getting the stuff there on time.

Once you have recognized those processes that are critical to the application of your business strategy, you know the ones that need to be constantly improved to stay on top of your game. I recommend that you have a formal review of these systems at least once a year to explore what else can be done to keep them in superb shape.

All other processes only require being adequate to good. To spend money and time on building a truly superb payroll system when your business advantage is speedy delivery is a waste of resources and poor management. I think it would behoove you to have a list of these processes and to regularly review that list asking yourself "Is this business process adequate?" Fix those that are not and then go back to work on your critical processes.

2.4 *Business Process Analysis*

Business Process Analysis is usually a formal process with the following steps:

- Determine the process start and end points.

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- List the intermediate steps.
- Figure out what each step is costing the company.
- Brainstorm your options.
- Project your cost savings for each option.
- Recommend changes.
- Develop an implementation plan for the changes accepted.

This is best done with a team approach whose members are heavily involved in the processes being studied.

2.5 *Business Process Errors*

What should you look for to improve a business process? The number one thing to look for fixing any of your processes is systemic errors.

Let's say you are doing an analysis of one of your critical systems – Purchasing. During this analysis you discover that the store managers are calling the purchasing department on average twice a day to follow-up on orders. Additionally, the purchasing department is calling each of the stores for clarification or discussion about store orders on average of 3 out of 10 orders.

A good purchasing system would not require a lot of follow-ups. Rather, the system would communicate to all what it is that they need to know without calling and interrupting other people. I think of each of these calls as a system error and when they start to exceed 20% of the transactions I think of them as being systemic.

These calls are costing you big time but the accounting system doesn't show it since the costs are hidden in various accounts on your financials. Most of the wasted money is buried in wages and their related payroll tax and benefit accounts. A $70,000 a year manager is costing the company around $32 per hour or $.53 per minute. This doesn't sound like much when you look at the minute rate but remember, each of these calls takes up time from two people. If the store manager calls twice a day and each follow-up call have an average length of only 5 minutes, the total cost per year is in the neighborhood of $2800 per store.

Reducing the error rate by improving the purchasing system so that it communicates all the information necessary to the purchasing department, accounting department, and store personnel will save you a lot of money, but it is only the tip of the ice burg. Store personnel who don't trust the purchasing system are probably sending in orders multiple times which is resulting in duplicated purchase orders. This is not so bad for core products, but will produce significant losses for special orders of products you don't normally carry.

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2.6 *Business Process Analysis Accuracy*

How accurate do I have to be when calculating what a system costs to operate? The answer is that not all that accurate. Our goal is to make better business decisions about managing our business processes. The amount of precision required to accomplish that goal does not involve computing the cost of a process to six decimal places. Rather, an approximate number to the nearest $1,000 or more is probably adequate to make the right decision. Spending the money for a detailed analysis with more precision will probably not produce any better decisions.

Then there is the problem, even if you wanted to be very precise you run into the fact that most small businesses do not maintain time records so trying to figure out how much of an employees time was spent in any one process can only be done with approximates. This is particularly frustrating to accountants who in their gut believe that any number not figured out to at least two decimal places is probably not accurate. It is a big mistake to avoid costing your processes because you don't feel like the accuracy is there. Basing your decisions on a series of approximates is much better than a wild guess.

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3 Customers – Your most valuable income producing asset.

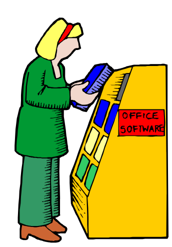
3.1 *Measuring Customer Satisfaction*

Focus groups and customer surveys can be very expensive and the results are usually wrong because people buy out of impulse and habit rather than some analytical process. People are notoriously bad predictors of their own future behavior.

Instead of asking questions about whether they are satisfied, how about asking them what it is they would most like to see changed? You are much more likely to get a real answer to what it is they don't like. Here is a cheap program that could provide real and usable information.

- Design a 5 question flyer asking them to rate the things they would most like to see changed from 1 to 5 with 1 being the most important. Examples might be store hours, inventory depth, less wait at checkout, etc. Make sure these are things that you are willing to work on if enough people request it.
- On the back of the flyer, put some lines to fold here along with your address and a 1st class postage stamp.
- Mark each flyer with a code to show the month and store distributed from.
- Have some one visiting the store from corporate hand them out to customers leaving the store. Do not let the possibility that the store personnel might contaminate the results be a factor in any manner.
- Track the returns on a graph including the % of flyers returned.
- Once you have enough of a trend to figure out what people would like to see the most improved, do something about it. Many times these can be relatively low cost changes with big results.
- Keep doing this monthly so you can see the trends.

3.2 *Value and Buying Habits*



Customer satisfaction is one thing, but what brings them back is their perceived value at that future time. I believe that most people will easily pay a 5% to 10% premium for good service. I don't have any scientific evidence to support this but it is a good rule of thumb.

To make good pricing decisions that maximize the return for good

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service, you have to know what your customers options are if they don’t buy from you. This means knowing what your competitors charge for similar products and their level of service. Using a “mystery shopper service” is one option to get this information. At the very least you should track all of the prices from their advertisements on a spreadsheet.

You might want to consider sending all new employees out to be a mystery shopper as part of their orientation. This assumes you didn’t hire them away from there to start with.

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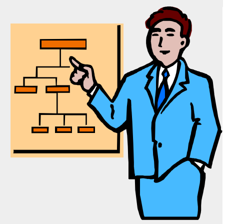
4 Employees

4.1 *Avoid being held hostage by employees*

Run regular ads in the newspaper advertising for positions. Interview at least one potential employee a week regardless of need and have your managers do the same. This policy will do the following for you:



- Keep your interviewing skills sharp.
- Let's your staff know that you have options.
- If somebody leaves, you will have a file folder full of resumes and interview notes that will give you a leg up on replacing that person, usually without the need of an employment agency.

4.2 *Employee Theft Prevention Program*

- I don't have any evidence to support this theory, but I believe that the other employees know when someone is stealing. The reason they don't report it is fear of reaction by those around them. Management's goal should be to make it hard for someone observing employee theft to not do something.
- Hire right by doing the screening necessary to avoid hiring an already proven thief. Do a criminal check and do follow-up on old employer references.
- Provide an initial training program designed to educate new employees on what they expected to do when they observe instances of possible theft. This program should have specific examples of what is unacceptable behavior.
- Provide an 800 number for people to call if they are observing questionable behavior.
- Have all new employees sign a statement that they understand your policies and what is expected of them should they observe behavior that is questionable.

4.3 *Use Employee Incentive Plans*

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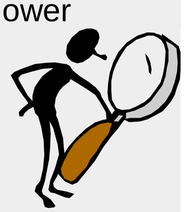
There are three things that move people behave in a certain way. Unfortunately two of them don't work. The only one that does is aligning the individual's self-interest with those of the business. The best tool for that job is employee incentive plans that have the following attributes:

- The goals are reachable.
- The results are perceived as fair.
- The rewards occur as close as possible to the activity that produced them.

4.4 *Analyzing Performance Problems*

Knowing when to change the job vs. when to change the people is one of the most critical jobs that any manager has and one that will have arguably the largest impact on your profits over all other management tasks. I highly recommend that you read the book *Analyzing Performance Problems* by Robert F. Mager and Peter Pipe. After you have read it, require that all your managers read it.

People generally want to do a good job. The trick for management is to be sure that they are not putting any impediments in the way of their employees' success. These impediments are usually not obvious and a little bit of sleuthing are necessary to bring them out into the open. Rewarding on only sales goals for example will not give a manager an incentive for supporting your goal of lower inventory levels. The manager gets a benefit by making sure that every possible product that a customer might want is on-hand and no detriment for not supporting the company's goal of lower inventory.



Analyzing Performance Problems is a flowchart approach to making sure that you understand why people are doing what they do.

4.5 *Employee vs. Contractor*

Trying to save some money by treating an employee as a contractor is a false saving because:

- Treating all of your employees as contractors would get you out of the overhead costs of paying and reporting employees as well as the company share of the payroll taxes. But, the IRS could easily determine what the true

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matter things is and access you with100% of the prior years payroll taxes plus the withholding that you should have done. Since this will happen some years down the road, the taxes, interest and penalties will probably bankrupt you.

- If you treat only a few select people as contractors rather than employees, your savings is only the company's share of the payroll taxes and maybe some worker's compensation premiums. You are already paying for the payroll system so there is no savings in overhead. This still may sound like the way to go but here is what happens. The employee isn't smart enough to pay estimated taxes and at the end of the year finds out that he is liable not only for income taxes, but the self-employment tax of 15.3% times net earnings. Ouch, he was expecting his normal refund. Now he is back at your door demanding assistance or complaining directly to the IRS.

4.6 *Outside Payroll Processing Services*

Unless you have a multi-state operation with unusually difficult payroll situations process the payroll internally. There is plenty of software available to make it easy.

Every analysis I have done to this date, comparing the cost of internally processing the payroll vs. using a payroll service like ADP, has shown that it is significantly cheaper to do it yourself.

Total Inventory Shrinkage

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5 Inventory

5.1 *Accounting Errors – What are they?*

- Receiving Errors
- Recording the wrong products received.
- Recording the wrong quantity received.
- Cost on product masters is not reconciled with vendor invoice.
- Shipping Errors
- Shipping products or quantities different from what is on the sales contract.
- Cost on product masters is not correct.
- Operational Errors
- Not recording products given to customers for goodwill reasons.
- Not recording products destroyed or thrown away.
- Cost on product masters is not correct for products given away or destroyed.
- Transfers of products between stores not recorded as out or recorded as received.

5.2 *Physical Count Errors*

- Not counting all items.
- Errors in quantities.
- Wrong product number on count sheets.
- Cost on product masters is not correct.

5.3 *Cutoff Errors when adjusting inventory to physical count:*

- Products received and included in physical count but recorded on books with a date after the count.
- Invoices by vendors recorded on books with a date on or before the count, but not actually received until after the count.
- Shipments to customers recorded on the books, but not actually shipped until after the count.
- Transfers of inventory between stores either counted and not recorded or visa versa.

5.4 *Budgeting to eliminate shrinkage – How much should you spend to fix the problem?*

If your shrinkage rate is 3% of sales and sales were equal to $5 million, then your unexplained loss is $150,000. If we use the University of Florida research as

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being reasonable, then we could assume that the loss has the following components:

Source of Inventory Shrinkage	**% of Loss**	**Loss Component**
Employee Theft	48.5%	$ 73,000
Shoplifting	31.7%	$ 48,000
Administrative Error	15.3%	$ 23,000
Vendor Fraud	5.4%	$ 6,000
		$150,000

Some of the administrative error is product that is legitimately given away to customers for some goodwill purpose and better accounting would not have changed your decision that it was the smart thing to do. You need to make a guess at just how big an amount this was and subtract it from the shrinkage in order to get the net amount of loss that was probably preventable.

In this example, let's say you have a good system for accounting for goodwill give-always and your net preventable loss is $150,000. I would be willing to invest up to $75,000 in next years budget on projects to reduce those losses provided the planning showed a potential of recovery my money in the first year. Repeat this process each year of producing an amount to invest and then develop a project plan to get your money back within the next 12 months. The end result is that you will eventually reach a point where your losses have been minimized and your inventory is under better control than any one competitor.

5.5 *EOQ – How to calculate the optimum quantity to order.*

It costs you money to process a purchase order, account for the receipt of the goods and to pay the invoice. These costs are called "Ordering Costs" and can be minimized by ordering large quantities to reduce the number of orders per year. On the other hand, it costs you to hold inventory. "Holding Costs" include the cost of the building to warehouse the goods, insurance, interest on the money invested, the cost of counting the stuff, and cost of losses due to inventory aging. Balancing these two cost categories – Ordering vs. Holding is what the "Economic Order Quantity" or EOQ formula is all about.

The math part of this is:

EOQ = $\sqrt{2cu/h}$
Where:
c = Cost of placing an order
u = Total annual units that you expect to order.
h = Annual cost of holding the product in inventory

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This formula looks like Black Magic and for years I had a hard time excepting that it might really work. Subsequently, I have found that it does have a mathematical basis in determining averages.

Let's say that your ordering costs are $100 per purchase order and that you can expect to order 500 widgets per year. You have also determined that your annual holding costs are 11% of the dollar amount of inventory held. The cost per unit, including freight is $250 each.

The formula would then calculate out as follows:
EOQ = $\sqrt{(2*100*500)\div(.11*250)}$
EOQ = 60 units

The proof for this formula is:
Ordering Costs = 500 units per year / 60 units per order * $100 = $833 per year
Holding Costs = $250 cost per unit * 60 units per order * 11% per year / 2 to average the inventory = $825 per year (difference due to rounding)

This formula does have some requirements to be used successfully:

- You have to be able to reasonably estimate demand.
- It does not take into consideration either the lead time or the number of days to actually receive the inventory.
- Quantity discounts are not considered in this formula but can be calculated in a second step.
- You can run this formula on a spreadsheet program or if you are using perpetual inventory software, there is probably an option built into the program.

See Also:
Holding Costs
Ordering Costs
EOQ in the Wikipedia – shows a nice graph to explain the concept.
EOQ Calculator

5.6 *Holding Costs – How to calculate what it costs you to hold inventory.*

Inventory Holding Costs are normally represented as a % of the dollar amount of inventory being held since they are primarily made up of costs relating to financing and storing the products. Costs that should be included in this calculation include:

- Interest – the opportunity interest rate that you could have earned if you had paid down your debt instead or invested in something other than your inventory.

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- Insurance – Talk to your agent and get a breakdown of how much of your premium is used to protect your inventory.
- Storage costs – You are primarily interest in storage costs that will vary with inventory levels and should not include areas of your warehouse that are used for administrative purposes or for which you have no other use other than to store inventory.
- Inventory count costs – The bigger the inventory the more expensive it is to count. I would definitely throw in at least a portion of any count costs.

Add up the storage costs, insurance premium, and count costs. Divide the total by the average dollar amount of inventory to get a percentage number. Add to this the interest rate to get a total percentage. The number will probably range between 10 and 15%.

See Also:
How accurate do I have to be?

5.7 *Ordering Costs – How to calculate what it costs you to process a PO.*

Ordering costs involve three different departments:
Purchasing departments cost to place and track a purchase order.
Receiving stores cost to receive the goods and communicate to the accounting department whether it is okay to pay the invoice.
Accounting departments cost to account for the purchase order, receiver, and vendor invoice.

To compute the purchasing department costs, use the following steps:

1. Interview the purchasing people and get an idea of what percentage of time they are generally involved with purchase orders including time spent to track their status.
2. Multiply the percentage times the total purchasing department costs for the last 12 months to get the total cost of processing purchase orders.
3. Determine the total number of purchase orders issued for that same 12 month period.
4. Divide the 12 month costs by the number of purchase orders issued to get the cost per purchase order.

To compute the receiving department costs, use the following steps:

1. Interview the warehouse people and any other store personnel involved with receiving to determine the approximate amount of time in a typical day or week that they spend in receiving products. Annualize the result and multiply it against their average wage plus benefits cost.
2. Divide the annualized costs by the number purchase orders issued, as determined previously, to get a cost per purchase order.

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To compute the accounting department costs, do the following:

1. Interview the Accounts Payable clerks and figure out approximately how much of their time is spent processing vendor product invoices and doing the related check runs as opposed to other invoices for office supplies, telephone, etc.
2. Determine the annual pay, benefits and taxes for the payroll clerks and multiply that by percentage in processing vendor invoices.
3. Divide the result by the number of purchase orders as determined previously.

Add up the three different components to determine the total cost of processing a purchase order. If you have never done this before, you will be mightily surprised. It is not unusual to see numbers in excess of $100 per purchase order.

See Also:
[How accurate do I have to be?]

5.8 *Perpetual Inventory – Getting the most out of it.*

Most of us think of perpetual inventory records as a way to see what is in the warehouse without taking the trip back there to check. However, its real advantage to you is to give you a fighting chance at controlling inventory losses.

Inventory is the most difficult asset to control and protect due to its sheer volume. Perpetual records break down the inventory into more bite size proportions. Consider adopting a policy similar to the following:

- All inventory items will be classed is either priority or non-priority. Priority items are high cost products that are particularly vulnerable to loss.
- All high priority items will be counted each morning before the start of business and the result compared to the perpetual records. Any differences must be researched immediately and the results reported to [Supervisor Name].
- [Number] non-priority items will be selected at random by [Supervisor Name] each morning for a physical count. All differences must be researched and the results reported.

The idea is to make inventory counts and reconciliations a daily event. This allows you to fix your systems and improve your processes. If the research cannot explain why there are differences, this is your sign that you need to step in and do something to prevent it from happening in the future. Spending all the money that perpetual inventory costs to operate is wasted if senior management will not listen to what it is saying.

5.9 *Shrinkage – What is it and what should you do about it.*

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Inventory shrinkage is all about the failure of your accounting system to explain where the entire dollar amount of your inventory went. It is the unexplained difference between the valuation of the inventory from a physical count and what the books show should be there.

Studies have concluded that the majority of these differences are due to theft, either from the employees or shoplifting. The University of Florida does an annual survey of crime in the workplace and came to the following conclusion:

Source of Inventory Shrinkage	**% of Loss***	**$ Lost**
Employee Theft	48.5%	$15.1 billion
Shoplifting	31.7%	$9.7 billion
Administrative Error	15.3%	$4.8 billion
Vendor Fraud	5.4%	$1.7 billion

Source: National Retail Security Survey, November 2002
(based on 2001 retail sales and inventory shrinkage)

What is the average amount of loss that you would expect to be normal? The survey's show that the big retail chains have shrinkage rates of less than 2%. Small retailers probably have an average between 3% and 4% in my experience, but I have not seen any studies addressing small businesses.

What should your strategy be for reducing inventory shrinkage?

Step 1 - Put it into perspective. It is theoretically possible to eliminate all accounting errors and prevent all fraudulent acts against you. Of course you would be bankrupt by the time you accomplished such a goal. Like all costs this one needs to be managed.

Step 2 – Resolve to be willing to spend a certain amount each year to manage shrinkage. In the absence of some other compelling reason, I would suggest an annual dollar amount between 25% and 50% of last year's shrinkage. As your shrinkage rate decreases, this investment should also decrease.

Step 3 – Develop a plan to eliminate accounting errors as the possible cause of shrinkage. Eliminating accounting errors leaves you with only fraud as the possible reason for shrinkage.

Step 4 – Develop a plan to limit employee theft.

Step 5 – Develop a plan to limit shoplifting.

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5.10 *Reducing Inventory Levels*

- Reduce your ordering costs so that it is cheaper for you to order more often.
- Get your suppliers to reduce the lead time necessary to get replacement products.
- On low-cost items, install a two-bin system where the product is ordered whenever the first bin is empty.
- Improve the forecasting of need for high-cost items.
- Track your inventory turns by store and discuss the results with the managers.
- Use the ABC system for managing inventory levels. "A" items are the 20% of products that make up 80% of the total inventory cost. "B" and "C" items are what is left.

5.11 *Transferring Inventory between Stores – When should you do it?*

Transferring inventory between stores in different geographical areas can get to be very expensive. On the other hand, holding onto inventory that is slow at one store is also costing you money. The trick is to then balance the reduced holding costs from moving the inventory against the freight costs. Simply take your estimated reduction in holding days time the cost per day and compare that against the freight cost. Normally, you would want to move as many of the slow items as possible, so do this calculation on a spreadsheet to see if it makes sense.

Remember, this book is about profits and not cash. If you have a cash problem or you think the product will never sell in the holding store, then you need to transfer the product and take the hit on margins that will result.

See Also:
Holding Costs

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6 Financing

6.1 *Profits vs. Cash Flow*

Profitability is not the same as cash flow and unfortunately you need to pay attention to both.

- Profits on your financial statements are an attempt to measure the economic reality of your business. They do this by recognizing sales when the product is delivered and the customer is legally bound to pay for it. The accounting department then tries to get all the expenses related to that sell recorded in the same time period to match up against those sales.
- If you cannot make a profit, then you will go out of business eventually.
- Long-term positive cash flow comes from profits. You can affect short-term cash flow with loans and new investments, but only profits are self sustaining.

6.2 *What to do if you are losing profits?*

- The golden rule here is the same as a sky diving emergency - do something different, immediately, before you hit the ground. Remember, it's not the fall, but the sudden stop that hurts. If you can positively identify the problem, then great, make the changes. If you can't identify the problem, then get someone new with fresh eyes to have a look and advice. You have to do something different.
- Consider what changes you can make to collect your money faster and pay it out slower. This only buys you some time.
- If you can't come up with a workable plan to do something differently, then quit. It is easier to start over with something rather than draining away all your assets in a futile attempt to keep doing what is not working. This is eminently logical and very hard to do.

6.3 *Use the right financing.*

- The best financing rate is zero and usually your product vendors will give it to you for a limited time. After negotiating price down to the best you can get, try and expand your open account time.
- Floor planning is the next best option for financing inventory beyond what the vendor will offer.
- Don't use credit cards, lines-of-credit, or any other short term money source to finance equipment. Unsecured loans are the much more expensive than a loan secured by equipment.
- Don't use short-term financing such as a line-of-credit to finance long-term operational needs.

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7 Fixed Assets

7.1 *Lease vs. Buy – Why would you want to own when you can lease?*

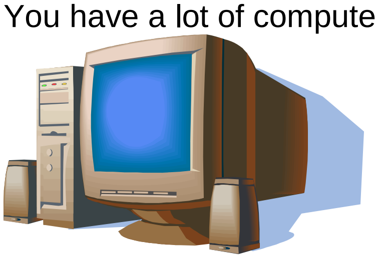
This is a popular question from automobile salespeople and the correct answer is "because it's cheaper". If you use a piece of equipment a lot it is almost inevitably cheaper to own it. Depending upon the cost, we can and will go through the exercise of calculating the costs of ownership vs. the cost of a lease, but 99% of the time buying is the best option.

7.2 *Extended Warranty – Is it worth it?*

Most of the time, the answer is "no". The only way these agreements would work for you is when the seller makes a mistake in estimating what it will cost them to service these agreements. It happens, but how will you ever know which one is the mistake?

7.3 *Managing Computers – Don't wait for them to fail.*

You have a lot of computers in your organization and your people are dependant



upon them. Hard drive failure is an inevitable event. If a particular computer has a lot of hard to replace work, replace or upgrade it every 3 years. If it is a workstation that sends its information off to a server for long-term storage, then replace or upgrade it every 4 years.

7.4 *Forklifts – Know what their economic life is.*

Keep a record of each forklift's expected life as determined by the manufacturer and replace them when they hit that limit. Light forklifts (less than 20,000 lbs) generally have an expected life of 10,000 hours or 5 years. Heavy forklifts can generally be expected to operate efficiently for 12,000 hours or 6 years.

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8 Measurement Systems – You can't manage it if you can't measure it.

8.1 *Sales Measurements*

Sales vs. Last Year
Same stores sales vs. Last Year
Sales per Square Foot
Average Sale – Money
Average Sale – Items

8.2 *Inventory Measurements*

Inventory shrinkage
Inventory Turnover
Availability/In-Stock %
Weeks supply on hand

8.3 *Buying & Merchandising*

Average purchase order cycle time

8.4 *Store Operations*

Sales per employee
Sales per labor hour

8.5 *Finance*

Return on Assets
Return on Capital
Acid Ratio/Current Ratio
Debt/Equity
Working Capital Ratio

8.6 *Employees*

Turnover rate
Training cost per sales associate

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Absentee Rate

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9 Freight

9.1 *Pick the Right Carrier*

This is a great once a year project. Review all your freight bills to see where you sent it and how much you sent on average. Then solicit proposals from several of the most likely candidates for the status of "Primary Shipper". The more volume you can provide to one particular carrier, the better a rate you are most likely to get.

Include the following information with your request for a quote:

- Product description – dimensions, weight, and whether or not it is fragile.
- Quantity – List by destination or geographic area.
- Frequency of shipments – How often will you be shipping?
- Packaging – Will the goods be palletized? (Avoid putting a crown on those pallets – it eats up the shippers' space if they can't stack.)

Verify their insurance before considering them a finalist.

Rank the responses and do your best to the company selected. It's volume that counts for the next year's prices.

9.2 *Shipping Inventory between Stores*

Generally, shipping inventory between stores should be avoided, but inevitably you end up with product at one store that is not moving while they can't keep it on the shelves at another store. To reduce the cost of transferring inventory consider the following options:

- Have all the inventory that needs to be moved sent to one store, preferably piggybacking on other shipments if possible. Once the entire inventory is accumulated hire one truck to take a full truckload with multiple stops. The TL cost is usually considerably less than the LTL cost even considering the extra charge for each stop.
- It is probable that you can negotiate reduced rates for these shipments since you probably don't care if it takes a week or two to get there.

9.3 *Negotiate Shipping Fees*

Fed-Ex and UPS will negotiate with volume shippers and many small businesses qualify. You need to ask.

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10 Professionals – Most are good, some are very bad.

10.1 *Lawyers*

You need to have the names of two of them. One is a general corporate attorney used to make legal agreements, review your sales contracts, etc. The second one is a specialist in handling employee issues such as sexual harassment suits.

10.2 *Consultants*

Avoid consultants that demonstrate your inability to think outside of the box with some sort of dot diagram in which you must connect all of the dots without lifting your pencil. This and similar demonstrations all come under the classification of "Stupid Consultant Tricks." There is no scientific evidence to support their theory that these tricks demonstrate anything about your ability to understand and solve problems. Remember, they probably had to look up the answer to get it right themselves.

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11 Vendors

11.1 *Vendor Rebates – Get all that is due you.*

The key to getting all of your rebates is having someone in charge that is required to report on the status of the program. The accounting department can greatly exist by having a general ledger account number for each rebate program.

The status report should be done annually and provide the following information:

- Vendor Name
- Program Name
- Last year's forecast of maximum dollars to be earned.
- Last year's actual rebate earned or received.
- Variance between forecast and actual.
- Factors explaining the variance.
- This year's maximum dollars expected to be earned.
- This year's actual rebate earned or received.
- This year's variance between forecast and actual.
- Name of person assigned the responsibility of maximizing the rebate program.

11.2 *Returned Goods Authorization (RGA) – How to track them.*

I am continually surprised by how much money is lost in this area. It is a pain in the nick for employees, so they don't send the stuff back timely. It is generally below management's radar, so they don't supervise.

This is an excellent area for a web-based software solution that will allow the stores to record a return from a customer and the eventual shipment to the vendor. The accounting department can then update each log entry with the date that the credit was actually issued by the vendor. A monthly email, listing all RGA listings that are over 60 days old without the credit, can then be generated to the manager in charge.

The management review is a must for this to succeed. The computer logs are an organized approach to the problem, but without management's interest a large portion of the entries will go stale without the vendor ever issuing the credits.

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12 Technology Issues

12.1 *Should you sell through the Internet?*

The cost of setting up a web-site with a shopping cart is relatively cheap. Probably under a $1,000 if you find the right people. However there is a painful reality to this. Just like a brick and mortar store, if they don't know it exists, they won't come.

Marketing that web-site name is the big expense. You need to get to the top of the search engines in your category of store in order to have a chance of someone buying. You can buy position from Google on the auction system which is a pretty neat thing. However, if your competitor's are bigger and better financed, they are more likely to be willing to pay for the top spots.

Let's say you get your site to the top spot. Now what is it going to take to get the user to actually buy? I recognize the Sears or JC Penny name and don't have any problem relying on their reputation to assure me that they will actually send me the goods. Your business may have a great local presence, but that isn't likely to help you with selling to people outside of your market area.

Finally, there is the problem of what to do if people should decide actually buy from you through your web-site? Do you have the processes setup to move product to them quickly through UPS, USPS, etc.? The big stores like Amazon do and they have the order processed within minutes. Can you compete with that?

12.2 *What should be your Internet Strategy?*

Use your websites to support your current customers, which in turn will hopefully produce referrals to their friends and neighbors. Here are just a few ideas to consider:

- Setup an ordering system so that your customers can order their products and pick them up on the way home.
- Provide your customers with free product information and perhaps an automatic email option for questions.
- Publish a monthly newsletter with information that will be useful to your clients.
- If you allow customers credit, then provide them with their account information on line.

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- Allow customers to sign-up for a news flash whenever you offer product sales.

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13 Travel Expenses

13.1 *General Policies*

- Avoid unnecessary travel by using the phone.
- Assign someone to be responsible for managing travel costs or use a Travel Agency. Require everybody to go through this waypoint.
- Have spending limits for hotels and airfare. Require special approval for exceeding these limits.
- Use per diem plans. It is amazing how cheap some people will travel if they can keep the difference.

13.2 *Video-Conferencing*

This is probably the way to go for the future. The technology is here now and you should see significant improvements each year for the next several years. Try http://sightspeed.com for an example of video phones in action.

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