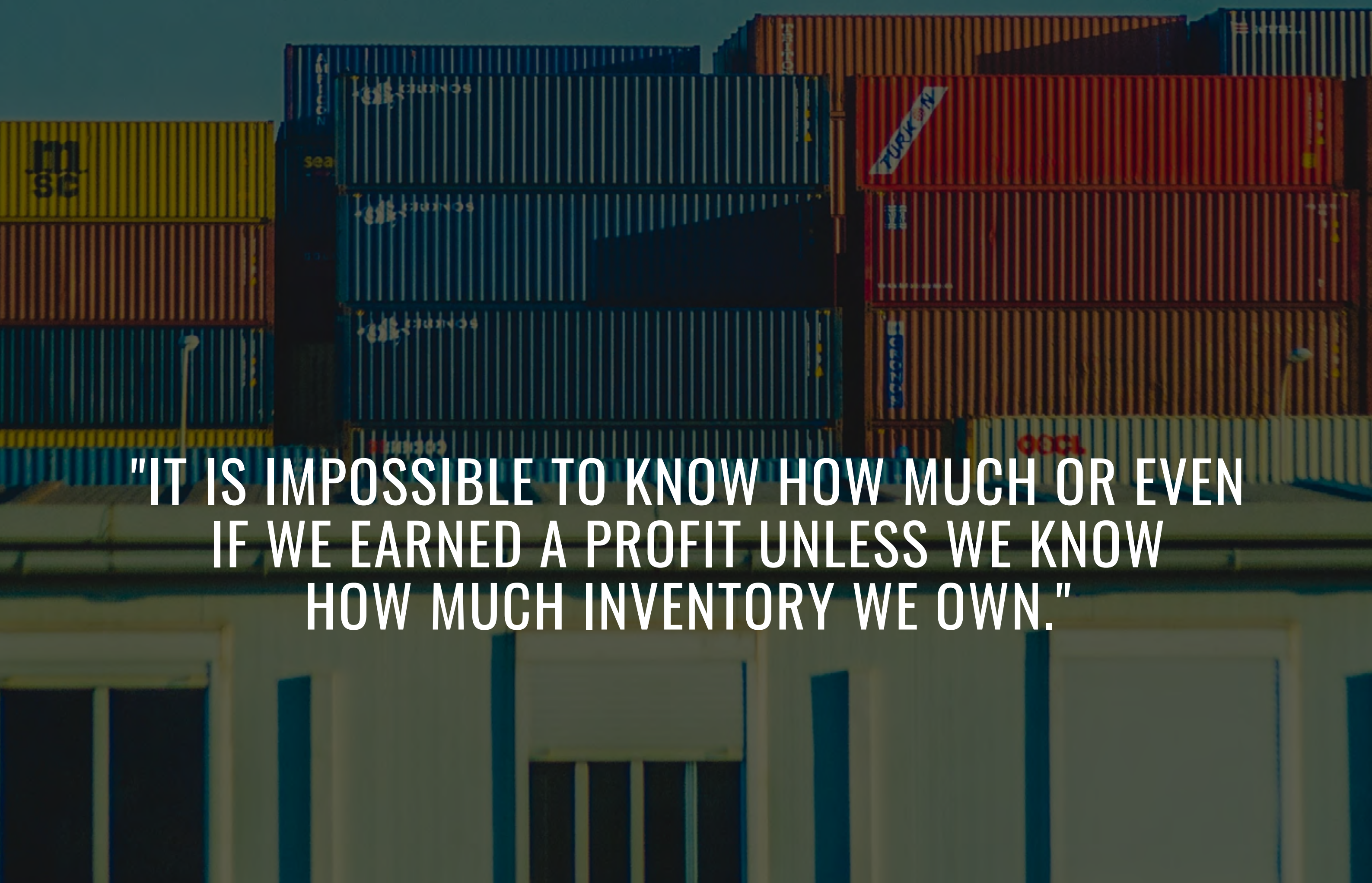
ANNEAL
BUSINESS COACHING

Inventory and the Contractor, Tradesman, and Service Company



"IT IS IMPOSSIBLE TO KNOW HOW MUCH OR EVEN IF WE EARNED A PROFIT UNLESS WE KNOW HOW MUCH INVENTORY WE OWN."

INVENTORY AND THE CONTRACTOR, TRADESMAN, AND SERVICE COMPANY

Inventory is one of the most confounding, difficult, threatening, cash-consuming, despised assets we can't live without. As a thorn in our sides, inventory ranks near the top, second only, perhaps, to Accounts Receivable.

TRACKING INVENTORY

If you're a contractor, tradesman, or a service company, look in your shop and in your service trucks. Are there any parts and materials there? Now look at your Balance Sheet. Is there a line labelled "Inventory" with a number next to it? If the answer to the first question is yes, then the answer to the second question should also be yes.

Inventory is an asset. It is made up of materials, parts, or goods that we own until we either sell them outright or as part of a job. As soon as we sell or use it, inventory transforms from an asset into an expense listed under Cost of Goods Sold.

My experience has shown that contractors, tradesmen, and service companies don't show inventory on their books in spite of the fact that their shops and trucks overflow with "extra" parts and materials purchased and paid for over the months and years. The parts and materials don't show up as assets because the bookkeeping department "expensed" them as cost of goods sold the day the bill arrived.

If we expense inventory, but still have it on hand tying up cash and cluttering up the shop, well, that's a distortion. It means our books are wrong. An Income Statement created under those circumstances overstates expense and understates assets. It will show lower margins and less profit than we actually earned.

INVENTORY'S IMPACT ON PROFIT

Inventory is a particular source of trouble for small businesses. It is hard to keep track of inventory, but it is impossible to know how much or even if we earned a profit unless we know how much inventory we own. That is a problem because every decision we make using the Income Statement relies on an accurate picture of margins and profit, which depend on cost of goods sold, which depends on how we handle inventory.

I am flogging the inventory horse because I cannot recall ever meeting a contractor, tradesman, or service company that kept an accurate count of inventory, which means I never met a contractor, tradesman or service company that produced an accurate Income Statement or Balance Sheet! (I am sure there are those who have, I just haven't met them.)

THE HIDDEN COST OF NOT TRACKING INVENTORY

Johnson, an electrical contractor, is a good example of how inventory can distort financial information. Johnson had been in business for two years when we met. He and his helper worked out of his truck because he didn't have an office or shop space. His company was small but he was (is) an intelligent, hard worker with solid ambition. Over our first year working together, he tripled sales and added two trucks to his fleet. Each truck was manned by a journeyman and apprentice. He also leased an office and shop, The combination of more work, a shop, and two more trucks meant that he had both the inclination and the space to order and store more "stuff."

Johnson kept good books (except for the inventory issue). We used them to estimate margins with budgeted labor and material costs for every job. We were always disappointed when we compared actual to budgeted performance. The planned margins never materialized. We looked at all sorts of possible reasons, but it was always apparent that material costs were too high.

His bookkeeper had expensed all the parts and materials, but a lot of them were still sitting in the shop or on the trucks when jobs were finished. They weren't really expense at that point. **They were inventory**. I exhorted, cajoled, and pleaded with Johnson to count the inventory, but he was always too busy. Finally, at my insistence, he and his wife committed to meet me at his shop on Labor day. Before we started counting, we made an "over/under" bet on the value of inventory on hand. I took the over.

It took a day to count inventory in the shop, two days to track down and count the inventory on his trucks, and another week to put a value on the totals. The end result was a big win for me. I dominated the over. Johnson was shocked. The inventory was worth almost three times his pre-count guess.

We made bookkeeping entries to reduce his Cost of Goods Sold by the value of the inventory and **it more than doubled net profit for the year** to date. The change not only transformed his net profit, but also his attitude. Always falling short of planned targets had had taken a toll and left him discouraged. Finding the reason and making the adjustments gave him back his confidence and enthusiasm. What he had assumed were operations failures turned out to be accounting entries.

If you order only what you use on a job by job basis and do not have an inventory, count yourselves among the lucky few. But before you do, go count the stuff sitting in your shop and on your trucks. You may be surprised.

DEALING WITH INVENTORY

There are three ways to handle inventory;

The first way is to ignore it. Expense everything you buy, when you buy it, and live with the fact that your financial reports will be perpetually wrong. You will never know how much money you really made and you will never have accurate information to help guide your operating decisions.

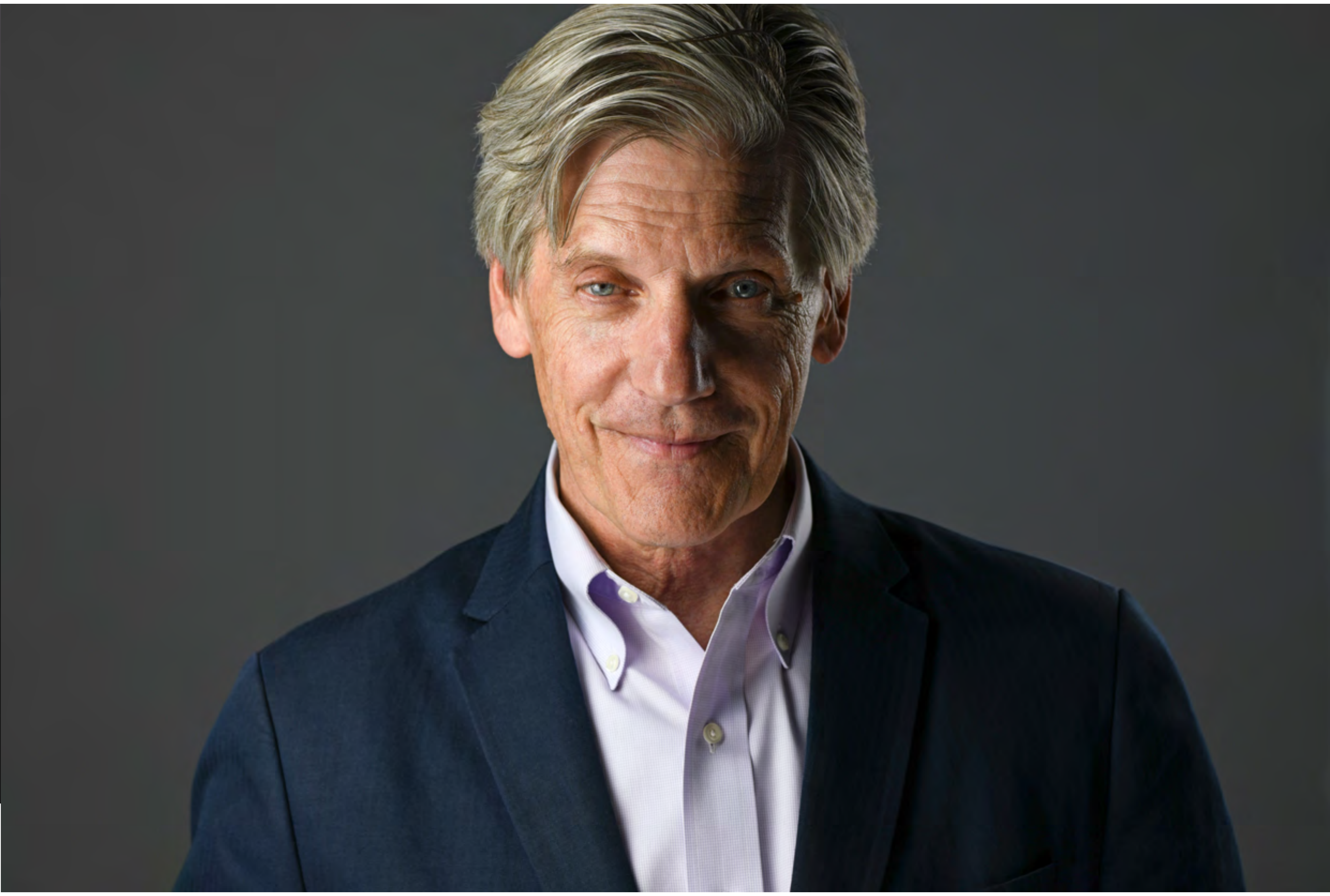
The second way is to keep perpetual inventory, which means you add items to inventory, item by item, when you buy them, and remove them item by item when you sell or use them. This is the accurate and proper way to keep inventory, but it is detailed, tedious work, and most small companies won't do it.

Fortunately, there is a third, compromise method. The compromise is to expense inventory when you buy it and count what remains at the end of each month. Give the numbers to your accountant who will make adjustments to your cost of goods sold and inventory accounts. That way your financials will right once per month, which is pretty good.

Start counting your inventory, and a lot of positive things will happen. Not only will your financials be right, but also you WILL become more organized in an effort to make the monthly counts easier. You'll avoid buying that next box of parts because you'll know you have fifty of them in the shop. You may learn that someone drove over a valuable part with the forklift, or (hopefully not) that some expensive components have mysteriously disappeared. You will discover where a large chunk of your cash went. Armed with all that knowledge, you can do something about it.

If we have parts on hand, we have inventory. If we have inventory, it should be included on our balance sheets. The only permissible alternative to keeping perpetual inventory is monthly counting and adjustment. We have to get it right. It's the only way to know where we stand and to have information we need to make decisions about the future.

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com



Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.