Cheat Sheet: Inventory Questions for Uncertain Times

Description

You worry about managing a business – it goes with the territory. And if you operate a business in today's environment, it's safe to say that you are worrying about things you never worried about before. Supply chain shocks, customer demand, staffing, and the rising costs of inputs have everyone worried. Frankly, today's combination of issues differs from what any living businessperson has ever experienced. When entering a strange territory, it's time to ask many questions. It's also important to ask the right questions that pierce the fog of uncertainty.

However, it's not enough to know the right questions to ask; you also need to understand what constitutes a good answer and recognize a troubling response when you hear it. As a turnaround expert, I'm usually called to fix problems that the company is in an existential crisis. But, before things get that bad, I think there is plenty to do to understand how prepared you are for the wild ride ahead. Below, you will find a list of questions you can use to help you see how well your business is doing and to help you manage risks moving forward.

In this article, let's ask a series of questions about inflationary pressures on inventory and cost inputs for the business. And I'll show you how to identify good answers from bad ones. Let's start with awareness questions and then look at actions.

When did management first see the signs of inflationary pressure on costs?

Inflation/price inflection has been around since March 2020. A satisfactory answer would be that they recognized change at time X and took "timely" steps to compensate pricing and revenue generation to ensure no shortfall. A wrong answer would be a list of excuses that customers will not accept price increases or only partial increases, yet costs have gone up, and gross profits have gone down.

Which inputs are affecting production costs the most?

Once we understand that, generally, costs have increased, we need to pinpoint the most significant factors. Was it increased labor cost, material costs, overhead, and/or SG&A? How many SKUs did this affect? A satisfactory answer would tell you that incremental cost increases on various goods and services have been passed along, but management was able to correct some lower-margin items. If not

too dramatic, inflation and price increases can allow a company to raise the profit margin on some of the lower performing items or items that sell very well but have a low margin. A SKU by SKU or category response is comforting. A bad answer generalizes that prices have increased, and management does not know how to compensate for that. Another weak management habit you have to watch out for is when they answer a data question with an anecdotal story about one customer. Anecdotes are memorable and help illustrate specific instances, but in this case, we need data.

Once we understand what has happened to date, we must think about what will happen next.

Were there areas where management anticipated prices to go up, but it did not happen?

Does management think these still hold risks of price increases and why? This question can help identify the particular factors affecting a specific industry. It also gives us an idea of how well management monitors the atmosphere. Satisfactory answers will tell you that leadership is in close touch with vendors and suppliers, has pinpointed specific areas where the labor and the cost of things will change, and can respond promptly when they do. That is the response of an initiative-taking management team which is a good thing. A bad answer would tell you that there is no way to know what will happen next, but they are hopeful that things will be more fortuitous in the future and leave you with anecdotes. This is a very reactive management style and should leave you uncomfortable. There are many things to learn about cost changes from talking to vendors.

Has management been able to resist some cost increases?

Which ones have not been accepted? Which ones have been rejected or deferred? As a result of this have priorities with vendors or suppliers changed? An initiative-taking satisfactory answer to this question is that if they have lost individual vendors or suppliers due to rejected costs or negotiations, they have already found alternatives or ways to lower their input costs. In this case, a bad answer would be that they cannot control who their vendors are and their customers, or they are sure that these are temporary cost changes and will go down.

If customers have accepted some cost increases, what is the impact as a percentage of revenue incurred to date?

You want to see a detailed list of changes in the data and how those affect the rest of the business. You do not want to hear that they can get you the information, but it would be difficult or time-consuming, meaning they do not have this information on hand. You are concerned whether it is management’s inaction or inadequate systems (not corrected by administration).

Next, let’s pinpoint how certain aspects of inflation, like rising interest rates and working capital changes, can impact the flow of their business during these tumultuous times.

A conclusive answer to this would be that management knows the variances in the budget, and they have an internal cash flow model with a borrowing base (bonus points for that answer) that tracks the changes in working capital components. They are keeping an eye on how the market and industry changes affect them. A solution you do not want to hear is that they do not know but know that customers are paying slower and are having trouble getting some supplies. They have no DSO (Days Sales Outstanding) numbers or no DIO (Days Inventory is On-hand) numbers. The impact of costs is unknown because they do not have a budget. The worst answer you can hear with this is why they are

talking to you; they need more money without pinpointing the need.

You need to know if suppliers have instituted price changes as permanent or semi-permanent or if there are temporary surcharges or spot price changes.

It is a good indicator for a business if they know what these are and can provide data on what they are. Not knowing this information can lead to a company bleeding money. Simply put, if you know the mechanism a vendor or supplier uses to determine his costs to you, you don't know when those prices might change again in fast-changing markets, leaving you under or overpriced in the market. Spot pricing can be deadly and common in commodity businesses, where management has quoted a price to a customer, obtains the materials for delivery, and does not see the change in cost until they have been locked into their price to their customers. In the opposite direction, you can assume costs are high, they start dropping, and while management can get supply, they are pricing themself out of good orders because costs are erroneously too high.

Answering these questions can help management better understand the factors that are affecting their cost of doing business. In the following essay, we'll discuss questions about the actions management should be taking to manage risk and keep the company on solid footing.

At this point we know that costs have gone up for a particular business, but has management passed on any of those price increases to the customer and to what percentage of customers?

The answer should be that the business recognized the increased costs as soon as they were imposed and immediately passed on. If management argues that customers will resist increased prices because they were raised last year or some similar excuse, this is a warning sign. Prices are continuously going up, and a business needs to be able to adapt in real-time to these changes quickly. A quick note: even if there is a recession, costs can increase – that is the definition of stagflation. While it is a completely different topic, inventory cost answers illustrate an awareness of what is happening around management and how that impacts their goods.

If management has not increased prices for the entirety of their business but has done it on a subset of customers for a subset of items, management should be able to isolate the channel or customers affected. "I don't know," or just the channel name without specific numbers is not a satisfactory response.

Has the price change been incremental? How many increases have been made?

This is a question you want to repeat for each instance, and what you want to hear is that price increases have increased as they have received the market changes. You do not want to hear that they are waiting for some arbitrary end-of-year date before raising prices. This is about market timing, not social/industry norms – likely set by customers in times gone by.

What is the acceptance rate of these changes?

It is a fact that some customers will not accept price increases, and then they will take their business elsewhere. This is how you determine the elasticity of demand for your product or service. A good proactive business should know who is and isn't accepting increases and how that relationship affects profitability. If they do not know the impact, it's a warning sign that the business is vulnerable to being

resourced, and margin erosion is on the horizon.

But losing a customer who is only marginally profitable isn't necessarily a bad thing. It allows the business to focus its energy and resources on more profitable customers. There may be non-monetary reasons to keep a customer, such as personal relationships, the prestige associated with a certain brand, or the assessment of long-term or tangential benefits. But you can't do that for many customers and can't do it for very long. Loyalty to a customer without profitability is deadly.

What about price changes that are permanent or semi-permanent?

Maybe there's just a small surcharge or a spot price change. This question is like the one we posed about how vendors have affected or been affected. But this question concerns how vendors have been passing along their cost increases and whether they are permanent or temporary. As in the other cases, the management team must know this answer. If they don't, it can wreak havoc on data and collections.

What is the competition doing?

If they increased prices, how did they do it? Who was involved in the decision? Have they changed standard costs? These questions and more are best handled by a senior executive team that has a description of these measures in a war-room manner. If they do not have this, can you be sure that the senior executive team is paying attention to the market?

How have price increases have affected credit terms payment processes or collection realizations?

A good answer will have a detailed analysis of receivables, and it is measured in DSO as a trend line over months. A business that has not managed this properly might have run out of capital.

This is also the time to ascertain if the funds from the government assistant programs increased demand in the market and if so, does management anticipate a reduction in demand as the programs wind down? If so, when?

A good business owner or management team will know that these programs were temporary, seeing the bubble in the market, or they know what changes are going to be permanent. A bad management team will have doubled down on inventory or expects the market to continue to grow exponentially but cannot justify why beyond a few deflecting anecdotes.

Finally, do we know what the return-on-investment assumptions and calculations management has made and where that capital will be deployed?

You want to see a detailed budget with managerial analysis relative to permanent market changes versus bubbles. If a business has become, so top line focused that any order is a good order, or if it is using market capital to buy up goods to hoard or have for supply chain issues, it may be in trouble.

Have you asked any of these questions recently?

Did you get good or bad answers? How a business answers these questions is imperative to judging whether it is prepared to address an increasingly volatile environment. A lot of the weak answers

indicate that a business is at the precipice of going downward but may not necessarily have begun that descent.

Now is the time to take a clear-eyed look at the cost side of the business and make sure management sees the whole field. As we said at the beginning of these articles, no living businessperson has experienced the range of factors business faces today. So, if you don’t like the answers, it may be time to bring in a set of outside eyes to help.

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Date Created
2022/08/25