Valuing Inventory Benefits for an ROI is Complicated – We're Here to Help!

Introduction

Some of The FiscalHealth Group's ROI (Return on Investment) sales tools include financial benefits related to better inventory management. These benefits may include reducing inventory waste and theft, improving inventory management productivity, and perhaps most significantly, reducing inventory held in stock while maintaining service levels.

As any CFO will tell you, inventory is expensive. It ties up money (working capital) that could otherwise be used for more productive investments (i.e., other high ROI investment opportunities, such as your product). Our goal is to help you understand how to value inventory reduction benefits as part of your sales efforts.

Key Inventory Management Terms

Let's first look at three key terms necessary to understanding how inventory is managed. These terms will assist us in understanding how financial benefits are generated when inventory levels are reduced.

1. **Annual Spend** reflects the organization's purchase cost (not what they sell it for) for the inventory that was sold (aka, cost of goods sold) for the 12-month period being evaluated.
2. **Average Inventory on Hand** represents how much was spent to purchase the organization's current inventory on hand. Because inventory levels constantly fluctuate, the "average inventory on hand" is used to provide a snapshot of the value of the inventory held during the year.
3. **Inventory Turns** is a metric used to identify how frequently the inventory is completely replenished, or "turned-over", during the year. If the inventory is turned-over more frequently, the organization will need less inventory on hand because it is replenished more often. Conversely, if the organization has more inventory on hand, it will be turned-over less frequently because it will not need to be replenished as often.

Inventory Turn Examples

Probably the best way to make sense of these terms is by using examples.

Current: Your client's inventory is not well-managed. It is too high.
Let's say your client's annual spend for their widgets is $20,000,000, and they keep average inventory of $3,333,000 on hand. They have so much average inventory on hand ($3,333,000) that they turn it only 6 times per year.

$$\frac{\$20{,}000{,}000 \text{ annual spend}}{\$3{,}333{,}000 \text{ inventory on hand}} = 6.0 \text{ turns}$$

We calculated the # of turns

Target: Your product can help your client increase their inventory turns.
You know from experience that the best practice for inventory turns of widgets is 14.0 — much higher than your client's current turn rate of 6.0. Your client's annual spend is still $20,000,000, but increasing turns to 14.0 means your client only needs $1,429,000 average inventory on hand.

$$\frac{\$20{,}000{,}000 \text{ annual spend}}{\$1{,}429{,}000 \text{ inventory on hand}} = 14.0 \text{ turns (best practice)}$$

We calculated inventory on hand

By using your product, your client can reduce their inventory of widgets by $1,904,000. The CFO places immense value on this improvement!

$3,333,000 (current) - $1,429,000 (target) = $1,904,000

Why is this a Benefit and How is it Realized?

When inventory is turned more frequently and the annual spend remains unchanged, an organization will have less inventory on hand. In the example above, inventory on hand is reduced by $1,904,000. The CFO can use this money for any other purpose — including paying for your product!

You might be asking, "*if less inventory is required, how is the inventory actually reduced so that $1,904,000 is in a bank account?*". In theory, you could return it to the vendor, but not all vendors accept returns, and if they do, they will certainly charge a restocking fee. Inventory is typically reduced by lowering purchases (annual spend) until the new lower inventory level is achieved. Once the new lower inventory level is achieved, purchases increase back to normal buying patterns.

This is a One-time Cash Flow Benefit and What That Means

Reducing inventory generates a one-time increase in cash flow that is realized by temporarily reducing purchases. It is a one-time benefit because you do not get the same benefit every year. It may take several months, or even a year, to complete the inventory reduction, but once the new lower inventory level is achieved, the benefit is fully realized. Reducing inventory is not an annual recurring benefit; it is a one-time reduction in inventory that results in a one-time increase in cash as inventory purchases are temporarily reduced.

1-time Inventory Reduction Benefit							
	Today	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Inventory Benefit	$0	$1,904,000	$0	$0	$0	$0	$1,904,000

Except When It Isn't!

You should always consider this reduction in inventory as a one-time benefit opportunity. Well, unless the CFO says otherwise! While the one-time cash flow benefit is the correct benefit calculation, occasionally, some CFOs will treat this benefit differently for ROI purposes. Instead, a CFO may prefer to treat one-time inventory benefits as a reduction in the finance cost of owning the inventory, known as the carrying cost.

$1,904,000	inventory reduction
5%	hospital carrying cost
$95,200	annual benefit

Treating this as a carrying cost benefit results in a recurring (annual) benefit of reducing interest expense on an income statement. This approach is also correct. This recurring benefit is significantly less than the one-time benefit, resulting in a lower ROI.

Annual Benefit of a 1-time Inventory Reduction						
	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Inventory Benefit	$95,200	$95,200	$95,200	$95,200	$95,200	$476,000

Summary

Reducing inventory on hand by increasing inventory turns can free up working capital (money) for other investment opportunities. CFOs greatly value this benefit. From an ROI perspective, treating this benefit as a one-time cash flow increase is the appropriate way to value this benefit. However, some CFOs may instead choose to treat this as an annual carrying cost benefit on their income statement. Your ROI model needs to be flexible enough to handle either approach.

About The FiscalHealth Group (FHG)

The FiscalHealth Group is the leader in identifying the Financial Value and Return on Investment of Healthcare solutions. We are dedicated to assisting Healthcare vendors quantify the Financial Value and ROI of their products by creating customized sales tools to communicate this value to economic buyers, including CFOs, CEOs, and other finance professionals. Visit www.thefiscalhealthgroup.com for more information.