by Alan Friedman

Addressing Inventory Quirks

Q: Alan, I have a two-part question. We are sold on GMROI (Gross Margin Return on Investment—see *Ask Alan*, August 2003) but don't know how to apply it to inventory that can be rented as well as sold. With this inventory, we don't know if it's going to be bought, rented or leased. Further complicating matters, items on lease contracts may be returned at any time.

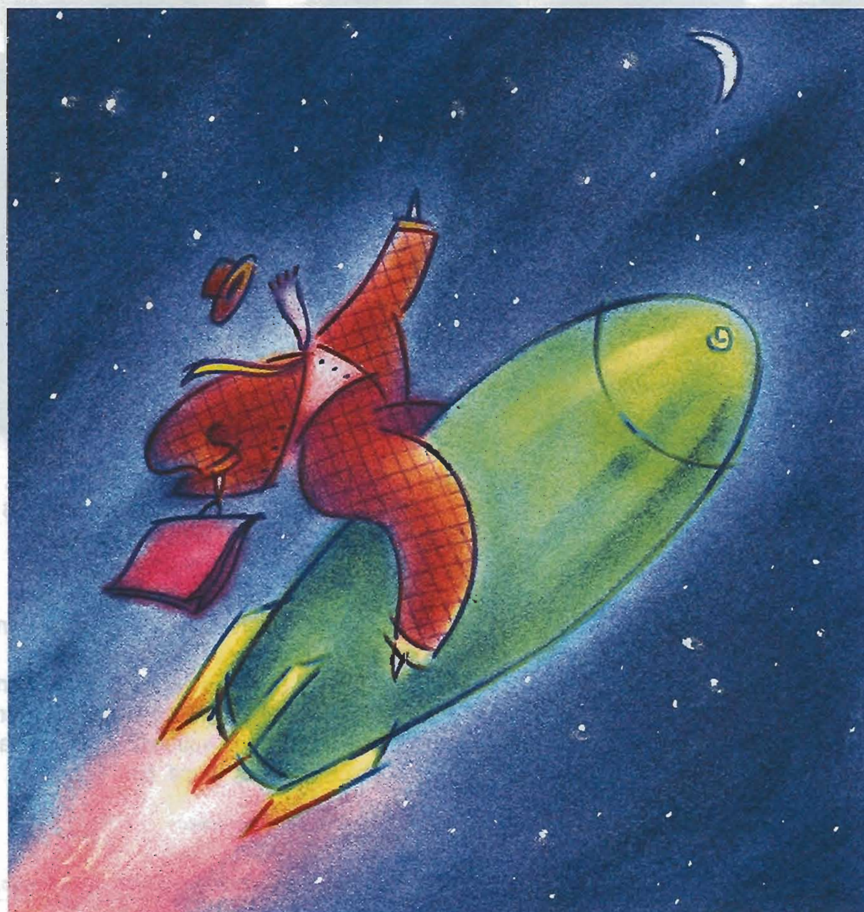
Second, in addition to annually, can GMROI be calculated on a daily, weekly, monthly and quarterly basis?

—Ken Foote, Buckley's Music
Halifax, Nova Scotia

A: Ken, first let me acknowledge your keen business sense for recognizing the importance of using the GMROI calculation as an analytical tool. Your confusion about the use of GMROI for inventory that "isn't necessarily sold" is understandable. And let me emphasize the importance of flying me on your Lear jet up to Nova Scotia to see a total eclipse of the sun—sorry, for a moment I thought I was Carly Simon. I can be so vain.

Like many music retailers, you not only sell instruments and related products, you also "rent" certain types of inventory (like weekend rentals of PA systems) and you "lease" other types of inventory (like band instruments). And you let your customers either buy or return those leased instruments at any time. And, yes, you have no clue whether your customers will buy, rent or lease this inventory when it is delivered to your store.

Your question about how to calculate GMROI considering these variables is an excellent one. The answer is that if you make certain reasonable assumptions, you can measure the effectiveness of your inventory and whether you are achieving profitability with "for sale," "for rent" and "for lease" inventory. Let's discuss.



First, let's once again define GMROI. GMROI stands for "Gross Margin Return on Investment" and measures the financial return on a retailer's investment in inventory. It is calculated by dividing the "dollar amount of average inventory" carried during a period of time into the "gross profit dollars" achieved during that same time period.

In my opinion, every music retailer should strive to achieve $1.50 (or better) for every $1.00 of inventory carried during the course of one year. Achieving this will automatically improve cash flow through increased sales profitability, less dollars tied up in idle inventory—or a combination of the two.

Because school music dealers, for example, have no clue whether their just-received product shipment will be sold or rented, I suggest moving all band and orchestra product out of "inventory" and into a fixed-asset category called "rental instrument pool" as soon as it arrives. Why? For four very important reasons:

1. The "intention" is to rent it;

2. The inventory should be classified as a long-term asset to attract long-term financing;

3. You can immediately start depreciating these inventory assets and realize tax savings;

4. You can now separately and effectively measure the profitability of inventory rented and inventory sold.

Let me elaborate on these four very important reasons.

Even though you don't know if you're going to sell, rent or lease this product, you probably have a pretty good idea of your intentions

or what historically happens. If most band instruments are going to be "leased," then put them into the rental pool. If most guitars, amps, keyboards, drums and print music are sold, keep them in inventory. If sound reinforcement products are both sold and rented, keep them in inventory until the day they are rented—then switch them to the rental pool and depreciate them accordingly.

The reason to classify rented and leased inventory as a long-term asset is to let the reader of your financial statements (i.e. your banker) know the income generated by this product is earned over a longer period of time than if it was sold. Accordingly, you need an extended period of time (i.e. three years) to pay for that product—hence the need for long-term bank financing.

The way to measure the profitability of your rental activity is to record gross rental income earned less the cost of renting those assets; that cost is recorded in the form of depreciation. By doing so, you can now measure the "profitability" of your rental assets (rental income less depreciation) and the "return" on your rental investment (gross rental income divided by the total cost dollars invested in your rental pool asset). We believe most retailers will achieve $0.50 to $1.00 of return annually (which translates to a payback period of 12 to 24 months) on their rental assets.

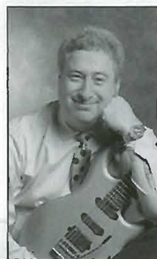
Finally, you can now properly use GMROI to analyze your "for sale" inventory because all rental assets have been removed. Your GMROI calculations will now yield a more accurate analysis of your overall inventory management because it's no longer being distorted by rental or leased assets (that will never be sold) sitting in inventory..

Finally, you can, and should, calculate your GMROI more often than annually. I suggest doing it monthly, after closing out your accounting records for that month.

Ken, you may have to read this article a couple times in order to fully understand what I'm saying. Once you do, please call me and explain so I too understand.

And in case you were wondering, the song "You're So Vain" was written about me.

Are financial questions keeping you up at night? E-mail yours to askalan @musicincmag.com. Please include your full name and company.



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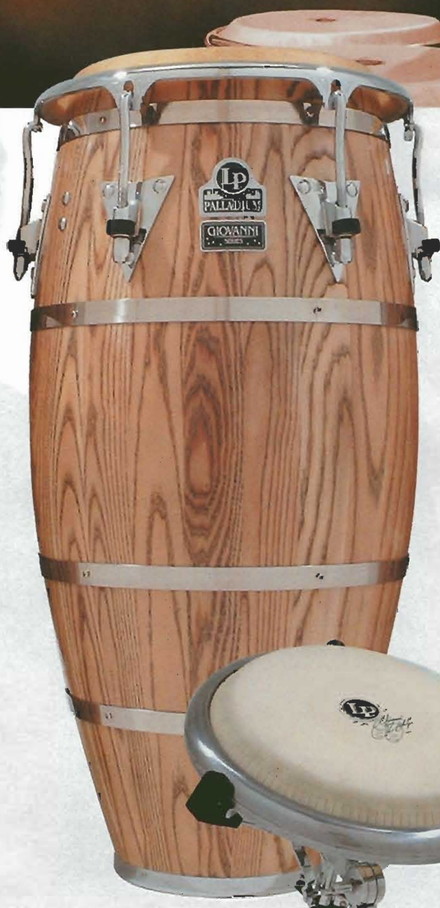

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