IDEAS

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ASK ALAN | BY ALAN FRIEDMAN

Let's Get Physical

Being an accountant isn't as much fun as it looks. I know that may surprise you, given the dynamic personalities of most accountants, coupled with their fun-filled work environments: a computer, ledger paper and library of exciting books like *The U.S. Internal Revenue Code*.

But what makes being an accountant especially tough is having to address accounting and tax compliance issues for each business, be it a sole proprietorship, partnership, "S" corporation and so on, all at the same time. If only there was a way to spread out our required work instead of cramming it into tax time every year. If only there was a way I could be young, handsome and rich, and live like Hugh Hefner.

The irony is that music retailers and accountants have similar problems. They need to know the true cost value of their inventory at the end of their business year for financial and tax reporting purposes. For that matter, they need to know their inventory value at all times during the year. But the year-end inventory valuation is especially important, as banks and creditors will rely on these financial statements for extending credit, and the IRS will rely on this information to assess a proper amount of tax.

Physical inventories at year end don't have to be a pain in the rear end

Accordingly, an inventory valuation will play the most material part in the *accuracy* of financial information. And most experts will agree, the only way to get an accurate inventory valuation is to physically count your inventory.

I'd like to assume that every music retailer understands the need and the importance of physically counting inventory. Throughout the year, inventory gets returned, stolen, damaged, sent back to the vendor, the list goes on. These circumstances will cause differences in quantities and distortions in valuation between book inventory and actual inventory. Remember: just because the computer says an item is in stock doesn't make it so.

Take a look at the chart on the next page, and notice the wide swing in bottom-line profitability that can occur by not having a proper count and valuation of your inventory.

This retailer was led into a false sense of profitability by not physically counting his inventory. It turns out that there were $10,000 in stolen goods that were still being carried in inventory. There were old drum machines, synths and samplers that had declined $15,000 in value below their original cost. There was also a $25,000 mistake in the "cutoff" of inventory — inventory that arrived on Dec. 31st and included in inventory that wasn't invoiced until days later, in January of the following year.

Guess what? This retailer paid taxes on that misstated profit.

No one of sound mind enjoys taking a physical inventory, which entails counting every item in the store, back storage room and warehouse — adding up to 5,000, 10,000, 20,000 or 30,000 products. Your employees can easily become overwhelmed and discouraged by the volume of data that needs to be collected, and will quickly adopt a "let's just finish this #@!%$&% physical and go home" attitude. To prevent this situation:

• Create a map of your store. Include every case, stand, shelf, fixture, rack and place where inventory is stored.

• Divide the store into departments or counting areas. Inventory counters should be assigned to geographic areas of your store, not product lines.

• Count surplus and slowmoving products before the scheduled physical inventory. Most store owners will try to count all their inventory in just one day so normal business can resume.

• Ship everything you can before the physical begins. If it's not in your storage room or warehouse, you don't have to count it.

• Don't move inventory while you count.

• Don't fill orders or receive inventory during the count process; it's too difficult to hit a moving target. You'll run the risk of missing or double-counting some products.

• As soon as counters are finished with a section of the store, start verifying their counts by doing some random test counts.

• Print and review discrepancy reports. After all counts have been entered in your computer system, discrepancy reports should be printed and all discrepancies should be thoroughly researched before the physical inventory is completed.

• After you've finished your physical count, sit down with everyone who participated and discuss the process, and incorporate their suggestions in your next physical inventory count.

By knowing the absolute dollar value of your inventory, you'll be able to analyze gross profit dollars and percentages, and derive meaningful inventory turns and GMROI trends. Ultimately, this will help you make decisive and educated buying and selling decisions, instead of simply guessing.

Physical inventories don't have to be long, burdensome or done all at once. Taking periodic counts of inventory throughout the year (called "cycle counts") can help alleviate the monumental task at the end of the year. Take a count of inventory by department at the end of each month (i.e. guitars in January, keyboards in February and so on). Also, make sure you employ bar code technology and good accounting software.

Diligently taking physical inventory counts might not be fun, but it's better than being a bean-counting accountant. **MI**

	IN THEORY		IN REALITY	
Sales	$1,000,000	100%	$1,000,000	100%
Beginning Inventory	350,000		350,000	
Plus Inventory Purchased	675,000		675,000	
Total Available Inventory	1,025,000		1,025,000	
Minus Ending Inventory	325,000		275,000	
Cost of Goods Sold	700,000	70%	750,000	75%
Gross Profit	300,000	30%	250,000	25%
Operating Expenses	250,000	25%	250,000	25%
Net Income (before taxes)	50,000	5%	—	—

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