Today’s Agenda

• Introduction – Why Does Valuation Matter?

• Inventory Valuation Methods

• Complexities Within Industry

• Asset Valuations and Ideal Costs
Introduction

1. Inventory: A significant portion of Balance Sheet assets

2. Valuation of inventory (+/-) can significantly impact income

3. Valuation Methods all yield the same answer when there is no change in the value of money (e.g., inflation, currency exch.)

4. With globalization, companies are constantly seeking new ideas to ensure that assets are deployed efficiently

5. Hence, changes to the value of money (e.g., inflation/ForEx) are critical and can pose challenges to managing inventory!
Methods for Valuation

• Multiple ways to derive inventory valuation (COGS)
  – From a Cost Flow assumption (e.g., FIFO, LIFO)
  – From an Averaging assumption
  – Specific Identification of value

• What Difference Does it Make?
  – Method chosen impacts amount of income recognized
  – Most businesses want to minimize assets invested
  – Some businesses have cyclicality to their inventory, with long inventory cycles (FISH)
Methods (continued)

• Cost Flow assumption: FIFO
  – Better indication of value of inventory on Bal. Sheet
  – Increases net income vs. LIFO (uses older inventory)
  – May increase tax liability as a result
• Cost Flow assumption: LIFO
  – Not as good an indicator of ending inventory value
  – May hide fact that inventory is old / obsolete
  – Results in lower net income because COGS is higher
• Average cost assumption
  – Produces results that fall between FIFO and LIFO
Complexities: Longer Cycle Inventory

• GAAP requires that inventory be valued….
  – At the lower $ of Market Value or Cost of Goods

• When inventory doesn’t immediately sell,
  – Different functions behave in rational / irrational ways
  – Accountants rationally enter a “reserve” (contra acct) to “impair” income at year end (conservative view)
  – Other parts of the business……?

• What Should that reserve be? Valuation?
  – GAAP allows for a lot of leeway
  – Companies have different goals for assets (RoNA, Collateral)
Tipping the Scale on Asset Impairment

Seeking Stability for Assets used as Collateral

Less willingness to Impair Inventory….

Seeking Greater Return on Net Assets

Willingness to Impair Inventory….
Complexities: Reverse Logistics

- Reverse Logistics not uniformly treated as process
- Costs of inventory not typically found in one area
- Companies hold other assets to process returns
- Costing for Reverse Logistics varies in industry
  1. Part of OpEx: Costed / Depreciated together with Ops
  2. Segregated: Costed / Depreciated by “RL” Department
- Sometimes, RL can find better uses for impaired inventory / spares
Who Should Pay for Inventory?

• If inventory is result of uncertainty, who controls?
• Should the costs be borne:
  – By one department?
  – By all departments?
  – By the department that failed to control uncertainty?
• What if the Reverse Logistics was treated (internally) as a profit center?
  – Would that impact decision-making?
  – Secondary markets could provide outlets for impaired inventory
Asset Valuation Methodologies

• Important to stop here and question our motives
• Why do we cost anything?
  – In order to control to budget…
  – In order to improve over time…
  – In order to provide incentives to management!
• Best answer to how much inventory is…..zero!
• What is “Perfect” Planning?
  – Procurement?
  – Manufacturing?
  – Service, etc.?

How do we incentivize each department to support “Zero?”
Ideas to drive to “Zero:” Drive down Uncertainty

• Planning: Better analytics on uncertainty
  – More IoT / sensing / modeling / responsiveness
  – On demand / production rate / inventory “trifecta”

• Procurement: Partner to reduce uncertainty
  – More flexible contracts, more JIT/VMI, ready access to credit
  – Accountability for part failure / customer incidents

• Production: Work to eliminate uncertainty
  – Postponement / JIT / Lot Size of 1
  – Accountability for part failure / customer incidents

• Reverse Logistics: Charge for uncertainties
  – Separate, but “integrated” budgeting with chargebacks
Measuring Effective Asset Utilization

• Many financial teams measure return on assets
  – Net Income / Net Assets
  – However, Net Income doesn’t always reflect Operational impact
  – Net Assets includes far more assets than Inventory

• Hence, more effective measure would be:
  – Gross Margin earned by inventory deployed or GMROI
  – Gross Margin / Net Inventory Assets

• Different Measures for Servicing Supply Chain
  – Cost per box returned
  – Cost per warranty claim
  – Cost per incident
  – Etc.
Key Take-Aways

• There are only a few options around valuation

• Strategy should drive valuation, not vice versa

• Asset Valuation costing should:
  – Reflect the true value of idle assets
  – Enable the right measures for your processes
  – Drive improvements to encourage “zero”
  – Drive review of how Reverse Logistics is funded
Thank You!

Questions

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