# Minimizing Your Inventory Costs, Maximizing Your Time

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## INTRODUCTION

Cost of Goods Sold (COGS) represents one of the largest expenses in any veterinary practice. Closely managing this expense is critical to overall financial success of the business. AAHA and other well-managed practices report average Cost of Goods Sold (COGS) of between 22% and 25%. However, by applying the principles discussed below, you can reduce COGS to as low as 8-12%, depending on your practice type. That's extra money that can be spent on employee salaries or new equipment for the practice.

Let's dispense the myth that keeping your COGS low requires you to spend endless hours each month counting every inventory item on your shelves or analyzing and tracking the changing costs of each item. Who has time for that anyway?

How can you benefit from reduced inventory costs and save time spent on ordering and managing inventory? To start, you need to first ask yourself if you understand your inventory.

## Do You Understand Your Inventory?

Whether you feel lost when it comes to your practice's inventory or you feel like you have inventory under control, now is the time to analyze your inventory usage.

This is especially important in emergency practice where you cannot afford to run out of inventory items in the middle of the night, even if you only use that item occasionally.

You should repeat this analysis at least every three to six months because product usage changes with seasons, doctors and even patients. Additionally, the availability and pricing of certain products may push you to use alternatives.

To understand your inventory usage (and by extension your Cost of Goods Sold), determine the answers to the following questions:

1) What are the most commonly used products in your practice?
2) What are the products that you absolutely cannot run out of (e.g. CPR drugs)?
3) How much do you use of each product?
4) What is the minimum amount of each product that you need to keep on the shelf?
5) How long does it typically take for your orders to be delivered?

## Categorizing Your Inventory Items

Categorize each of your inventory items into the following categories:

### Category AA - Must Never Run Out

This includes drugs that are used every day in your practice such as maropitant, propofol, non-steroidal anti-inflammatories, etc. Non-drug AA items might be surgical gloves or possibly blood product filter lines.

### Category A - Important but You Have a Back-Up Plan

Category A items would include regularly used antibiotics or other drugs that you would not want to run out of, except that you have a backup such as a different milligram tablet that could be split into two or possibly a liquid formulation. An example would be Clavamox 62.5mg tablets. If you ran out of this drug, you could easily prescribe the Clavamox 125mg tablets and order a half a tablet twice a day. Alternatively, you could prescribe the Clavamox 62.5mg/ml liquid formulation.

Non-drug category A items might include 3cc syringes. You definitely don't want to run out of these! But if you did, you would have 6cc syringes as a backup.

### Category B - Rarely Used but You Must Have This in the Practice

Category B items might include CPR drugs such as naloxone, atropine or epinephrine. You never want to not have them on hand when you need them!

### Category C - On the Chopping Block

Finally, category C items are those products that you ordered once and used only a couple times. This includes any drug that is for a non-emergent disease such as Apoquel or Cytopoint, or any drugs that were special ordered for a specific doctor that is no longer with the practice.

It is important to keep in mind that these categories are very specific to your practice. What might be a category AA item for one practice, could be a category C item for another practice. You need to be in tune with your practice's culture and your doctors' philosophies about how they choose to practice medicine. The types of patients you see and the location of your practice will also dictate to a large extent how you categorize your products.

Finally, product categories may also be affected by availability of product. For any clinic, Fentanyl might be considered an AA product. However, current opioid shortages have likely pushed Fentanyl to an A category product.

## Just in Time Inventory

The idea behind this inventory management philosophy is to order your products so that they arrive "just in time" before you run out. In order to maintain such a system, you need to understand the following terms with respect to each product:

- **Turns:** the number of times the product is sold or used in a time period such as a month or a week.
- **Reorder Point:** The level of inventory which triggers an action to order more of that item.
- **Lead Time:** The time it takes a supplier to deliver the products once an order is placed.

Speak to your distributor rep and request a 12 to 24-month history of your orders. This will help you identify your turns, lead time and determine an appropriate reorder point for each product.

## Inventory Counts

It is probably not necessary to count all of your inventory every month. However, it is important to perform some inventory counts on a regular basis to maintain control and minimize inventory shrinkage.

Some practice managers—especially those with a background in retail—may elect to NOT count inventory and manage their inventory on a perpetual system. This means that the value of inventory on hand is calculated based on the purchasing and sales records.

The shortcoming of this method of valuing inventory is that it does not account for any shrinkage—products that leave the practice, whether through theft or through unintentional neglect in capturing charges on client invoices.

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Additionally, a perpetual inventory system does not adequately account for usage of drugs and products in the clinic.

For these reasons, it can be challenging to use this type of inventory management system in veterinary practice.

However, if you do choose to use a perpetual inventory record, platforms such as Arbimed are being used successfully in the human medical and dental fields and can be easily adapted to the veterinary industry.

By cycling your inventory counts by area, you can reduce the amount of time you spend on any given day counting your products. You may choose to cycle your counts based on either location e.g. pharmacy, treatment, surgery, central storage etc., or on type of inventory e.g. injectables, prescription drugs, surgery supplies, etc.

In general, we recommend counting one inventory location or type every week on a 6- to 8-week cycle. Of course, this may vary depending on the number of locations or inventory categories in your practice and on the product usage or turns in your practice.

## Budgeting for Your Orders

Many practices place their inventory orders based on history and possibly on bulk promotions being offered by distributors. However, the best way to keep your COGS down is to base your orders on *anticipated usage* using your budgeted or expected revenues and your current and targeted COGS percentages as a guideline.

First, determine what your expected daily revenues are for each day in the upcoming week. Second, multiply the daily revenue budget by your current COGS percentage and your COGS percentage goal to determine the maximum and minimum amounts that you should budget to spend on inventory purchases for the week.

**Table 1: Budgeted COGS for the Week**

| | Budgeted Revenues | COGS % current | COGS % goal | Budget high | Budget low |
|---|---|---|---|---|---|
| Sunday | $17,000 | 20% | 18% | $3,400 | $3,060 |
| Monday | $7,000 | 20% | 18% | $1,400 | $1,260 |
| Tuesday | $3,000 | 20% | 18% | $600 | $540 |
| Wednesday | $2,000 | 20% | 18% | $400 | $360 |
| Thursday | $6,000 | 20% | 18% | $1,200 | $1,080 |
| Friday | $5,000 | 20% | 18% | $1,000 | $900 |
| Saturday | $10,000 | 20% | 18% | $2,000 | $1,800 |
| Total | $50,000 | 20% | 18% | $10,000 | $9,000 |

Next, track the cost of each vendor's orders and the cost of all orders for the week. Also track the cost of the products actually received, since this will sometimes differ from the order due to vendor errors and products being on backorder.

Finally, calculate the COGS percentage for the orders placed as well as for the products received.

**Table 2: Cost of Orders for the Week**

| Vendor Orders | Order Total | Received Total |
|---|---|---|
| Midwest | $8,642 | $7,963 |
| Zoetis | $564 | $564 |
| IDEXX | $745 | $745 |
| TOTAL COST<br>COGS % | $ 9,951<br>20% | $ 9,272<br>19% |

Download a fillable spreadsheet with these calculations.

## Timing Your Orders to Maximize Cash Flows

It is important that you understand exactly when your distributors' cut-off dates are scheduled so that you can time your orders appropriately to maximize your cash flows. Using a credit card to pay your distributors' will also help to maximize cash flows, provided you pay the credit cards off each month.

You will also earn rewards points that can be used for continuing education travel costs or employee incentives!

Paying for inventory purchases every 60 days (using a credit card) rather than monthly or weekly will:

a) give you more money in the bank in case of an emergency,
b) earn you more interest, and
c) get you a bunch of credit card rewards points!

## Inventory Standard Operating Procedure

Download an example of how this works.

All practices should take the time to create an inventory standard operating procedure (SOP) to help provide consistency for the team and document processes. When your team supports inventory management programs, outcomes include maintaining COGS at a low percentage and effective just-in-time inventory levels. It is recommended to have digital access to your inventory manual so it is available for internal use and reference at all times. This can be set up utilizing Dropbox, iCloud, Google Drive, etc.

An inventory SOP should include the following:

### A Complete List of Distributors/Vendors

This should include the contact name, account number, statement dates and order cutoff dates for all vendors or distributors. The list should be updated at least quarterly to ensure that all employees have access to this information. This allows for continuity if the practice manager is away on vacation or if the person in charge of ordering leaves the practice unexpectedly.

## Key Inventory Metrics for the Practice

This should include historical order quantities and value and COGS%. It should also include budgeted or forecasted COGS% by month and by year. Other metrics to be recorded include reorder points, inventory turns and historical lead times by product category.

## A list of all Controlled Substances

This is based on the DEA and State requirements. Special ordering, receiving, storage and usage procedures for controlled dugs should be well documented. Your controlled drug log should be reconciled to your controlled drug inventory at least weekly by two employees.

> "...you can **reduce** your COGS and **improve** the practice cash flow in an **efficient** manner..."

## Inventory Counts

This section should outline who is responsible for counting which inventory locations or categories and how often such counts should be performed. It should also address how to deal with overstock items, short-dated or expired inventory items, and what do if inventory items are on back order.

It should also address how to “count” large volume items that are dispensed in smaller quantities (e.g. a 150ml bottle of metronidazole suspension that is 40% full).

## Ordering

This includes the names of the employee(s) responsible for placing the orders with the vendors, how frequently orders are placed, and any limitations on the dollar value of each order. You should also document *how* inventory should be ordered e.g. phone, fax, or on-line.

## Receiving

How (and by whom) inventory items are received, compared to the purchase order, and placed into the appropriate location. It is important that this section take into account timing of getting inventory items into the correct location and recording them in a perpetual inventory system, if appropriate.

It is also important that the employee receiving the inventory have access to the original purchase order and that the items *received* are diligently checked against the items and the quantities *ordered*. The employee responsible for ordering should be notified immediately of any short-delivered items for follow up with the vendor(s).

## Invoice Authorization and Payment

This section outlines who is responsible for receiving vendor invoices, comparing them to the purchase orders and the check-list of items received (because vendors will often short-deliver but not remove those items from the invoice!), authorizing the invoice for payment and processing the payments.

## Segregation of Duties

This is an important accounting internal control policy that is *essential* to safeguarding inventory from theft, fraud, or error. Essentially, segregation of duties (also called separation of duties) requires that a complete task be completed by more than one employee.

In the case of inventory, this means that one employee is responsible for the ordering, a different employee is responsible for the receiving, and a third employee is responsible for authorizing the invoice and a fourth employee is responsible for paying the vendor.

This is extremely important in our industry where we are ordering medical supplies and drugs, including controlled drugs. If all of these tasks were being performed by the same employee, that person could place an order for an item, pocket the item on receipt from the vendor and then authorize the payment. In smaller practices with fewer employees, appropriate segregation of duties can sometimes be difficult to achieve.

Keep in mind that for inventories of controlled drugs, additional safeguards should always be in place. For example, two employees should be responsible for receiving any controlled drugs or counting controlled drug inventory.

With COGS being one of the largest expenses in an emergency practice, it is imperative to closely manage this expense. By applying the practices suggested here, you can reduce your COGS and improve the practice cash flow in an efficient manner. Who doesn't want extra time and money for their practice?

## ABOUT THE AUTHOR

Originally from South Africa, Dr. Fuhrman has extensive experience in financial consulting and corporate accounting. As a CPA and a graduate of Colorado State University's combined MBA/DVM program, she offers a combination of veterinary practice ownership, financial, and management skills. Dr. Fuhrman is a veterinary consultant and nationwide industry speaker. She is also a practice owner and practitioner, as well as an adjunct faculty member at Midwestern University's College of Veterinary Medicine.