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# How terms can help you turn a profit

***By Jim Morphey***
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Discover the impact that inventory payment terms can have on profits. One of my colleagues devised a potential modification to incorporate the additional impact of repayment terms into the Gross Margin Return on Inventory Investments (GMROII) formula. The modified GMROII formula is:

$$\text{Terms Impact to GMROII} = \frac{\text{Gross Margin}}{(1-\text{Gross Margin}) \times \left(1 - \frac{\text{Terms}}{360}\right)} \times \text{Inventory Turn}$$

If you have a spreadsheet handy, you might want to plug in the formula and compare different products and lines to see how they compare. Below is an example of how you might set-up the formula in a spreadsheet:

| | A | B | C | D | E |
|---|---|---|---|---|---|
| 1 | Variable | Input | Formula | Results | Equation |
| 2 | GM | 10% | GMROII = | 33% | =B2/(1-B2)*B4 |
| 3 | Terms | 60 | Modified GMROII= | 40% | =B2/((1-B2)*(1-(B3/360)))*B4 |
| 4 | Turn | 3 | | | |

To complete the ratio, you will need average gross margins, average inventory turns, and average payable terms for the evaluating time period. If you need help calculating these numbers please visit the Featured Articles in the Wells Fargo CDF Learning Center.

The modified formula will produce a different GMROII if the repayment terms are different for calculations that include two unlike product lines with identical gross margins and similar inventory turns. Supplier terms can make a huge difference in your daily cash requirements, debt leverage, and daily liquidity to meet your obligations. Some suppliers offer longer repayment terms and inventory financing through third-party finance companies. Other suppliers promote accelerated payments through the use of Early-Pay Cash Discounts (EPD).

If you have excess cash and want to take advantage of EPD always remember that once the supplier has been paid for the inventory, your money is now “trapped in boxes” in the warehouse. Down the road the investment may come back to haunt you if you experience a cashflow crisis. If so, your business may need to significantly discount the products to generate cash.

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Ideally, matching inventory payment terms to your inventory turns will help maintain cash liquidity. Gross margins, while important to profitability, are just one part of the "three-legged stool." To maintain balance, you must also consider inventory turns and supplier terms. To maintain a solid and sustainable enterprise, particularly in an environment where going to the bank for emergency cashflow requirements is difficult, you need to consider all three.

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Jim Morphey is the vice president of corporate development for Wells Fargo Commercial Distribution Finance (CDF). Morphey has more than 40 years of management experience in consumer finance, trade credit, and most recently with domestic and international inventory financing, as well as factoring. Morphey's career has been devoted almost entirely to the domestic consumer electronic, appliance, and outdoor power industries. His background includes executive assignments in operations, credit, and relationship management at the national level with Whirlpool, Whirlpool Financial Corporation, Transamerica Distribution Finance, and senior relationship assignments at GE Capital.

Morphey received a Bachelor of Science in Management from Northern Illinois University. He was a member of the Association for Finance Professionals (AFP). He earned professional certifications from The National Association of Credit Management/Credit Research Foundation (NACM/CRF) Graduate School of Credit & Financial Management held at Dartmouth College, and also from The Finance, Credit, and International Business Association (FCIB). Morphey has published many articles on the topics of inventory management as well as cashflow. He also helped produce a six part video series on a variety of cashflow topics which may be found at www.cdf.wf.com/learningcenter. Morphey and his family reside in southwestern Michigan.

*Questions about this article can be directed to james.a.morphey@wellsfargo.com*

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