Is Your Inventory Accuracy Really As Good as Your Auditors Report?

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It is close to the end of the financial year, and your company’s auditors have to report your year-ending inventory for the financial reports. How the auditors measure the inventory accuracy can give you a false sense of comfort about how well your operation is really performing.

The Dreaded Physical Inventory

For many companies, the proverbial, pain-in-the-rear, physical inventory is a must. This includes shutting down the warehouse or distribution center for a day or more, disrupting the normal flow of products to plants and customers, and paying gobs of overtime while people count, recount, double check the recount, enter the data, print reports, perform a complicated reconciliation process, make adjustments, print more reports, and clean-up the empty pizza boxes. The entire process starts weeks in advance and is monitored by both internal and external auditors.

Cycle Counting

An increasing number of companies have found a better way with regular cycle counts of the inventory. They count some portion of the inventory on a regular basis, usually daily, with more frequent counts for higher value or higher velocity items. The auditors use summary reports for reporting the inventory accuracy and resulting inventory balances for the financial reports. In many companies, cycle counting replaces the need for the annual physical inventory.

What Is Your Inventory Accuracy?

A question in an Operational Audit is, “What is your inventory accuracy?” The most common answer is something like “99% - plus” with many managers reporting 99.6% or even higher. However, the next question should be, “How do you measure that accuracy?” It is amazing how many operational managers struggle to answer how the operation’s accuracy is measured. To some, it’s the first time they ever had the question.

Two Methodologies: Financial Accuracy and Operational Accuracy

What surprises many experienced operational managers is there are two methodologies for measuring and reporting inventory accuracy. Because there are two, managers need to identify which methodology they are using when reporting results. The first is the “Financial Accuracy”. The second is the “Operational Accuracy”. Most companies use only the Financial Accuracy.
The **Financial Accuracy** is the net dollar difference of the adjustments after an inventory, and it is the measurement used by most internal auditors and accounting firms. It answers the question, “Are the processes sufficient in controlling the inventory to avoid making large adjustments to the inventory value on the company’s books?”

The Operational Accuracy answers two very different questions. The first is, “When we promise the last unit of an item to a customer, do we have a high degree of confidence we actually have the unit?” And, the second question is, “Can we be very sure the picker will find the right item, in the right quantity, at the specified location, on the first try?”

**The true measure of a distribution center’s accuracy is the operational accuracy.** A very high level of operational accuracy is needed to maintain superior customer service and excellent productivity. When Customer Service has taken an order for something based on inventory availability, a bond is established with the customer. When Distribution has to backorder the item because they cannot find the item or allocated quantity, the bond with the customer is broken.

For productivity, there is too much wasted time in a distribution center when an associate cannot find the right item, in the right quantity, in the right location as specified in the picking instructions, regardless of whether those instructions are paper-based or electronic. Once the picker cannot find an item, the search begins and productivity starts a downward spiral. It is also common for a picker who cannot find the item to enlist another person’s help. When this happens, there are two people doing one person’s job. Talk about declining productivity!

The operational accuracy is stricter than the financial accuracy. Here are two examples:

**Financial Accuracy Example**

An example of the financial accuracy is as follows:

- Assume there are two stockkeeping units (SKUs) in inventory
- Each SKU’s value is $1.00
- The “book record” is for 100 units on hand of each SKU.
- A physical inventory counts each item;
  - One has 101, and the other has 99.
- The net dollar difference is zero dollars.
- Inventory accuracy is 100%.

**Operational Accuracy Example**

An example of the operational accuracy for the same scenario is:

- The entire inventory is in two storage locations. The units of one SKU are in one storage location, and the units of the second SKU are in a second location.
- The physical inventory counts each location;
  - One SKU has 101 units, and the other has 99.
• Both locations are incorrect compared to book record.
• Inventory accuracy is 0%.

While the examples are simple, the point is clear. The operational accuracy is usually very different from the financial accuracy unless the operational accuracy is very high. If the operational accuracy is 99% or better, the financial accuracy will also be extremely high.

**Real Life Examples**

Two recent Operational Audits completed by Distribution Design show real life examples. Both companies had the Financial Accuracy measured by auditors greater than 99%, and distribution management did not think accuracy was a problem. Based on the accountant’s view, the companies were not losing a significant amount of inventory.

However, Distribution Design found the Operational Accuracy at the first company was 85%. And, since the company’s system did not track quantity by location, this means that only 85% of the picking locations had the correct SKU! The second company’s operational accuracy was just 66%. This means that 34% of the time when pickers went to the specified location, they did not find the correct item and/or there was an insufficient quantity to complete the customer’s order!

**The First Attempt**

Another big difference between the Financial Accuracy and the Operational Accuracy is when to record the accuracy measurement. With the Financial Accuracy, the process expects all investigations, corrective transactions, and reconciliations are complete before the measurement is recorded. For financial reporting, this approach is correct.

However, the Operational Accuracy is based on the “first pass” counting. **The true measure of the operation’s accuracy performance is on the first count.** If the location count (SKU, quantity, and sometimes lot) does not match the inventory record, the accuracy is zero. (Note: you can assign a tolerance factor for very low value items and weigh-count items.) If the cycle count associate finds the item in the immediately adjacent location, the original count is still wrong, and that is the measurement to report. It is good to make the corrective transaction, but for measurement purposes, the first count is the official one.

**The Real Purpose of Cycle Counting**

Many people think that the purpose of cycle counting is to fix errors. While that is true as a side benefit, the real purpose of cycle counting is to **minimize the time an error is allowed to perpetuate.** The longer an error exists, the greater the decline in productivity. Most errors are on faster moving items because they are received, moved, picked, and shipped more often and in higher quantities so the chance of errors occurring is higher.

There is a compound effect from declining productivity when inventory errors continue because more and more associates will encounter the error and have their work disrupted as they try to complete their tasks efficiently. To minimize the productivity loss from the error, most associates will take the product they need from an alternate
location without processing a transaction. That compounds the problem as another location is now incorrect.

The best warehouse operations do some cycle counts daily. It is a high priority, and they never skip a day. It is also good to count faster moving items more frequently than slower moving items. Putting the counting resources into items that are more likely to have errors minimizes the disruption to productivity and customer service.

**Cycle Counting is Not Just Counting**

Cycle counting is a lot more than counting and reconciling. It is:

- Communicating to associates about the accuracy.
- Tracing errors to individual associates for additional counseling and training.
- Analyzing the errors and identifying fixes to processes that will address the types of errors that are the most common.
- Posting cycle counting metrics on a daily or weekly basis.
- Spending five minutes at the beginning of a shift in reinforcing what the errors are and what types of practices are causing them.
- Supervisory follow-up.
- The focus needed for continuous improvement.

If the associates believe that management is serious about improving inventory accuracy, they will respond in a positive way.

**What Inventory Accuracy Really Is to a Distribution Operation**

Inventory accuracy is NOT the net dollar difference after all counts and corrections. While operational managers will have to continue to assist the accountants with the financial inventory, resting on those laurels of a 99%+ net dollar difference does nothing to address the likely productivity and service issues that exist in the operation.

The only good measure of how well the operation controls inventory is the Operational Accuracy, the percent of locations that are 100% correct for SKU, quantity, and sometimes lot. If the operational accuracy is below 99%, there are real opportunities for process improvement that will have a positive impact on productivity and customer service. If the Operational Accuracy is greater than 99%, the Financial Accuracy will thrill the accountants and customers, and the case will be made for no more weekends doing physical inventory and finishing the last of the cold pizza before you shut off the lights.